Supreme Court, U.S.
FILED

041547 MAY 17 2005

OFFICE OF THE CLERK

No.

IN THE
Supreme Court of the United States

SOUTHERN CALIFORNIA WATER COMPANY,
Petitioner,

v.

CALIFORNIA PUBLIC UTILITIES COMMISSION,
Respondent.

On Petition For Writ Of Certiorari To The California Supreme Court

PETITION FOR WRIT OF CERTIORARI

F. CURT KIRSCHNER, JR.
(Counsel of Record)
PATRICIA A. SCHMIEGE
O'MELVENY & MYERS LLP
Embarcadero Center West
275 Battery Street, 26th Floor
San Francisco, CA 94111
(415) 984-8700

Attorneys for Petitioner

QUESTIONS PRESENTED

1. Whether the California Public Utilities Commission may require a privately owned public utility to involuntarily convert privately-held water rights to property dedicated to the public use.

2. Whether the involuntary conversion of private property to property dedicated to the public use amounts to an unconstitutional taking of property without just compensation.

PARTIES TO THE PROCEEDING

Petitioner is Southern California Water Company ("SCWC"). Petitioner was the applicant in a general rate case proceeding before the California Public Utilities Commission.

Respondent is the California Public Utilities Commission ("CPUC"). The CPUC is the state regulatory agency that sets rates and establishes rules for the public utilities subject to its jurisdiction.

RULE 29,6 DISCLOSURE

Southern California Water Company is a California corporation. Southern California Water Company is a wholly-owned subsidiary of American States Water Company. No publicly held company owns ten percent or more of the stock of American States Water Company.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED i

PARTIES TO THE PROCEEDING ii

RULE 29.6 DISCLOSURE iii

TABLE OF AUTHORITIES v

PETITION FOR A WRIT OF CERTIORARI 1

OPINIONS BELOW 1

JURISDICTION 1

STATEMENT OF THE CASE 1

A. Factual Background 3

REASONS FOR GRANTING THE WRIT 4

I. CPUC DECISION 04-03-039 EFFECTS AN UNLAWFUL TAKING OF SCWC'S PRIVATE WATER RIGHTS UNDER THE UNITED STATES CONSTITUTION 5

A. Taking Private Property 6

B. Dedicating Property To A Public Use 7

CONCLUSION 10

TABLE OF AUTHORITIES

Page(s)

CASES

Allen v. Railroad Comm'n
(1918) 179 Cal. 68 .....6, 7, 8, 9

California v. United States
(1978) 438 U.S. 645 6

California Water & Telephone Co. v. Public Utilities Comm.
(1959) 51 Cal.2d 478 6

Del Mar Water Light & Power Co. v. Eshleman
(1914) 167 Cal. 666 .....6, 7, 8, 9

Greyhound Lines, Inc. v. Public Utilities Comm.
(1968) 68 Cal.2d 406 8

Kavanau v. Santa Monica Rent Control Bd.
(1997) 16 Cal.4th 761 6

Lamb v. California Water & Telephone Co.
(1942) 21 Cal.2d 33 8

Marin Water & Power Co. v. Town of Sausalito
(1914) 168 Cal. 587 .....8, 9

McIntyre v. Consolidated Water Co.
(1928) 205 Cal. 231 .....6, 9

Merrill v. Southside Irrigation Co.
(1896) 112 Cal. 426 7

Palazzolo v. Rhode Island
(2001) 533 U.S. 606 6

Phillips v. Washington Legal Foundation
(1998) 524 U.S. 156 6

Producers' Transp. Co. v. Railroad Comm'n
(1917) 176 Cal. 499 8

Producers' Transp. Co. v. Railroad Comm'n
(1920) 251 U.S. 228 6

Richfield Oil Corp. v. Public Utilities Comm'n
(1960) 54 Cal.2d 419 .....7, 8, 9

Riverside Land Co. v. Jarvis
(1917) 174 Cal. 316 9

Thayer v. California Dev. Co.
(1912) 164 Cal. 117 8

PETITION FOR A WRIT OF CERTIORARI

Petitioner Southern California Water Company prays that a writ of certiorari issue to review the order of the California Public Utilities Commission in this case.

OPINIONS BELOW

The order of the California Public Utilities Commission at issue in this Petition, Decision (D.)04-03-039, is unreported, and is reprinted in the Appendix ("App.") at 1a.

JURISDICTION

SCWC appealed the CPUC's order to the California Supreme Court, which denied discretionary review. The California Supreme Court issued its ruling on February 16, 2005, summarily denying SCWC's petition for writ of review of CPUC Decision 04-03-039. This Court has jurisdiction pursuant to 28 U.S.C. § 1257(a).

STATEMENT OF THE CASE

This case is about the right of a public utility to determine whether to dedicate its private property to the public use.

Southern California Water Company is an investor-owned public utility subject to the jurisdiction of the California Public Utilities Commission. SCWC's principal business is the production and distribution of water throughout California for domestic, industrial, municipal and other purposes.

In 1964, SCWC acquired 32,000 acre-feet per year (AFY) of rights to use surface water from the South Fork of the American River. In 1966, SCWC and the City of Folsom, California, agreed to become co-tenants of these 32,000 AFY of surface water rights, with SCWC assigned the right to use 10,000 AFY of surface water and the City of Folsom assigned the right to use the remaining 22,000 AFY of surface water. Almost three decades later, in 1994,

SCWC entered into another agreement with the City of Folsom to reallocate to the City the exclusive right to use up to 5,000 AFY of SCWC's 10,000 AFY entitlement of surface water rights.

It is undisputed that during the entire thirty year period (1964-1994) prior to SCWC's transaction with the City of Folsom, SCWC had ***never used for any purpose*** the 5,000 AFY portion of surface water rights that it assigned to the City of Folsom. Indeed, SCWC was only using about 3,500 of the 5,000 AFY of surface water rights that it retained for itself.

In its March 2004 Decision 04-03-039, the CPUC held that the 5,000 AFY of surface water rights that SCWC reassigned to the City of Folsom, even though unused for thirty years, was nonetheless "useful" under Section 851 of the California Public Utilities Code. The CPUC held that these surface water rights "could potentially be used to serve [SCWC's] customers." D.04-03-039, App. 55a. In taking away SCWC's ability to freely dispose of its unused property, the CPUC has violated SCWC's constitutional rights.

The proper analysis is not to treat, as the CPUC did, SCWC's excess surface water rights as "equivalent to an insurance policy that helped to guarantee that the utility would have the water supply necessary to meet its duties to the public." D.04-03-039, App. at 56a. Rather, the test is whether the property has been dedicated to the public good. Property that has not been used in any fashion for thirty years is not "necessary or useful" in performance of utility duties and is not dedicated to the public good.

A. Factual Background

In December 1963, SCWC purchased the assets of the Natomas Water Company for approximately $1 million. Those assets included fifteen wells, three reservoirs, fifteen pressure tanks, 1.3 miles of lined transmission mains, about 5,400 services, various parcels of land, tools and equipment, and three pickup trucks. Natomas' sole source of supply of potable water to its customers at the time was groundwater pumped from the fifteen wells.

As a result of the sale, SCWC also succeeded to the rights of Natomas Water Company to divert up to 32,000 acre feet annually from the South Fork of the American River. However, Natomas did not own a surface water treatment plant to treat water diverted from the American River, and thus had never used any of its surface water rights to serve potable water to its customers.

Having no use for the 32,000 AFY of surface water rights it acquired, SCWC almost immediately transferred to the City of Folsom the majority of the water rights. In 1966, SCWC entered into an agreement with the City of Folsom, whereby SCWC and the City became co-tenant owners of the 32,000 acre feet annual right to water from the American River. Under the terms of the 1966 agreement, SCWC was allocated the exclusive use of 10,000 acre feet of water annually and the City was allocated the exclusive use of 22,000 acre feet of water annually. The CPUC approved the transfer of these water rights to the City of Folsom, finding that SCWC ***did not need these water rights*** to provide service to its customers.

In the early 1970s, SCWC constructed a surface water treatment plant and began using small amounts of its 10,000 acre feet in water rights to serve its customers. Over the years, the maximum amount of water rights that SCWC used in any year to serve customers was 3,451 AF.

In 1994, SCWC entered into a second agreement with the City of Folsom to transfer to the City a 5,000 AFY portion of SCWC's remaining 10,000 acre foot entitlement to take water from the American River. Before entering into the 1994 agreement with the City of Folsom, SCWC examined its current and future supply needs for its service territory, as well as applicable water rights legal issues. Based on its review of all the information it gathered, SCWC determined that it did not need to obtain approval from the CPUC before it could enter into the agreement with the City. SCWC reasoned that the 5,000 acre feet of water rights to be reallocated to the City were surplus and had never been dedicated to a public use. Moreover, SCWC concluded that sound financial and engineering considerations, including relevant water quality rules and regulations, counseled against future use of the 5,000 acre feet of surplus water rights.

Ten years later, on March 18, 2004, the CPUC issued its Decision (D.)04-03-039, ruling that SCWC was required to seek CPUC authorization before it could reallocate to the City of Folsom the right to use 5,000 acre feet of water annually from the American River. The gravamen of the CPUC's ruling was the holding that the 5,000 acre feet of water rights reallocated to the City of Folsom were "useful because they enhanced SCWC's ability to meet future water supply contingencies," thereby serving as a form of "insurance" for future water supply. D.04-03-039, Conclusion of Law 20, App. at 122-123a.

REASONS FOR GRANTING THE WRIT

The CPUC's ruling that SCWC was not free to transfer water rights that had not used for the thirty years that SCWC owned the rights is wrong as matter of law, logic and policy. The CPUC has acted unlawfully and has violated SCWC's constitutional rights. This Court should ask whether a pri-

vately owned utility must retain its excess surface water rights that have been unused for thirty years as "an insurance policy" for future water supply needs. The Court should also ask whether utility property is "useful" and dedicated to the public good simply because it "could potentially be used to serve customers." SCWC respectfully submits that the answer to each of these questions is "no."

Decision 04-03-039 is unlawful and must be annulled. Certiorari should be granted and the case remanded to the California Supreme Court, with directions to vacate the CPUC decision.

I. CPUC DECISION 04-03-039 EFFECTS AN UNLAWFUL TAKING OF SCWC'S PRIVATE WATER RIGHTS UNDER THE UNITED STATES CONSTITUTION.

Simply put, the crux of the CPUC's Decision 04-03-039 is its conclusion that the 5,000 acre feet of excess surface water rights were "useful" because such surface water rights "could potentially be used to serve [SCWC's] customers." D.04-03-039, App. at 55a. The CPUC defines "useful" in Decision 04-03-039 as "property that is capable of being used to serve customers." D.04-03-039, App. at 56a. With respect to SCWC's excess water rights, the CPUC concludes that "the water rights that were leased to Folsom were equivalent to an insurance policy that helped to guarantee that the utility would have the water supply necessary to meet its duties to the public." D.04-03-039, App. at 56a.

In this case, the CPUC has unconstitutionally construed its own jurisdiction to extend to that portion of SCWC's excess surface water rights that remained purely private property not dedicated to a public use. The United States constitution prohibits the State of California and its agencies from taking private property for public use without providing just

compensation to the owner. *See* U.S. Const. amends. V & XIV. The federal takings clause is made applicable to the state through the operation of the Fourteenth Amendment. *Palazzolo v. Rhode Island* (2001) 533 U.S. 606, 617; *Kavanau v. Santa Monica Rent Control Bd.* (1997) 16 Cal.4th 761, 773.

A. Taking Private Property

For purposes of determining whether private property is taken under the federal constitution, the existence and nature of the underlying property right is ascertained according to state law, since the federal constitution protects rather than creates property interests. *Phillips v. Washington Legal Foundation* (1998) 524 U.S. 156, 163-64. This is especially appropriate since the laws pertaining to allocation of water rights within California are defined by state, not federal, law. *See California v. United States* (1978) 438 U.S. 645, 675.

The involuntary conversion of private water rights to rights dedicated to public use constitutes a taking of those private rights and entitles the holder to just compensation. *See Producers' Transp. Co. v. Railroad Comm'n* (1920) 251 U.S. 228, 230-31; *Allen v. Railroad Comm'n* (1918) 179 Cal. 68, 89, *cert. denied* (1919) 249 U.S. 601; *Del Mar Water, Light & Power Co. v. Eshleman* (1914) 167 Cal. 666, 680; *McIntyre v. Consolidated Water Co.* (1928) 205 Cal. 231, 237. As the California Supreme Court has stated, to allow regulation of private water rights as if dedicated to public use "would destroy the value of all water rights." *Allen, supra*, 179 Cal. at 84. Such a forced dedication cannot be justified as an exercise of the police power. *California Water & Telephone Co. v. Public Utilities Commission* (1959) 51 Cal.2d 478, 489.

The extent of a dedication is dependant upon the facts and circumstances of the case. A dedication of some portion of SCWC's appropriative water right to American River water does not convert all of its water rights to a public use, rendering all such water rights subject to regulation by the Commission. *Del Mar Water Light & Power Co. v. Eshleman* (1914) 167 Cal. 666, 681. Because SCWC had never previously dedicated to a public use the excess 5,000 acre feet of water reallocated to the City of Folsom in 1994, the CPUC may not assert jurisdiction over those surplus water rights.

B. Dedicating Property To A Public Use

The California Constitution, Article X, section 5 and Article XII, section 3 and their implementing statutes, Public Utilities Code sections 216, 241, and 2701, have consistently been interpreted to mean that the jurisdiction of the Commission over public utilities is limited to persons or companies that have dedicated their property to public use. *See Richfield Oil Corp. v. Public Utilities Comm'n* (1960) 54 Cal.2d 419, 425-33, *cert. denied sub nom. Southern Counties Gas Co. of California v. Public Utilities Comm'n*, 364 U.S. 900.

The "dedication" of property to public use, including the dedication of water rights, occurs when that property "is designated, set apart, and devoted to purposes of sale, rental, or distribution" to the public. *Merrill v. Southside Irrigation Co.* (1896) 112 Cal. 426, 433. The basic requirement for dedication of water rights is that the holder of the right makes an affirmative representation that it is willing to deliver water under that right to any member of the public who pays the applicable water rates. *See Allen, supra*, 179 Cal. at 88-89.

The acquisition of water rights by a private company and the dedication of those rights to the public are two separate steps, and dedication must chronologically follow acquisition. *See Allen*, *supra*, 179 Cal. at 83; *Thayer v. California Dev. Co.* (1912) 164 Cal. 117, 126. The mere acquisition of water rights does not constitute a dedication of those rights. Dedication occurs only when the company actually makes the water rights available for use by the public. It is only through the affirmative action of a private water rights holder that those rights are dedicated to use by the public. *See Allen*, *supra*, 179 Cal. at 83; *Thayer, supra*, 164 Cal. at 126. "To hold that property has been dedicated to a public use is 'not a trivial thing' and such dedication is never presumed 'without evidence of unequivocal intention.'" *Allen*, *supra*, 179 Cal. at 85 (citation omitted).

The cases also hold that the owner of an appropriative water right has strict control over the terms of dedication. First, a dedication to public use must be voluntary. *See Greyhound Lines, Inc. v. Public Utilities Comm'n* (1968) 68 Cal.2d 406, 416; *Producers' Transp. Co. v. Railroad Comm'n* (1917) 176 Cal. 499, 504. In particular, the CPUC "has no power to compel a corporation which owns property in private right, and has not dedicated it to any public use, to apply it to a public use of any kind." *Del Mar Water, Light & Power Co. v. Eshleman* (1914) 167 Cal. 666, 677.

Second, a water rights holder may limit the amount of its rights dedicated to public use. Numerous cases have held that a company may dedicate a part of its water rights from a single source to public use while retaining a portion of the water supply for a purely private use. *See Richfield Oil Corp. v. Public Utilities Comm'n* (1960) 54 Cal.2d 419, 431-32, *cert. denied sub nom. Southern Counties Gas Co. of California v. Public Utilities Comm'n*, 364 U.S. 900; *Lamb v. California Water & Telephone Co.* (1942) 21 Cal.2d 33, 40; *Marin Water & Power Co. v. Town of Sausalito* (1914)

168 Cal. 587, 605 (conc. opn. of Shaw, J.); *Allen v. Railroad Comm'n* (1918) 179 Cal. 68, 81-82; *McIntyre v. Consolidated Water Co.* (1928) 205 Cal. 231, 236; *Riverside Land Co. v. Jarvis* (1917) 174 Cal. 316, 322, 324-25; *Del Mar Water, Light & Power Co. v. Eshleman* (1914) 167 Cal. 666, 681.

As stated in *Del Mar Water, Light & Power Company*, a private company owning a water right "may dedicate a part of it, only, to [public] use, reserving the remainder for private purposes or for private sale or disposition as he sees fit." *Del Mar*, 167 Cal. at 681. A company is not required to make an additional amount of water available to the public beyond the quantity originally dedicated, even if the water is not in use for other purposes. *Id.* at 679-80. A company may use property it has not dedicated to public use "as it sees fit" so long as it does not prejudice any of its public utility obligations. *Richfield Oil Corp., supra*, 54 Cal.2d at 436; *Marin Water & Power Co. v. Town of Sausalito* (1914) 168 Cal. 587, 596.

The rule established in these cases applies directly to the effect of CPUC Decision 04-03-039. Of its entitlement to 10,000 AFY of surface water rights in the American River, SCWC had dedicated 5,000 acre-feet to its customers for drinking water. But SCWC never dedicated the remaining 5,000 acre-feet to those customers. Consequently, SCWC's customers have no interest in SCWC's purely private water rights. In D.04-03-039, the CPUC deems SCWC to have made such a dedication without any action by SCWC and contrary to SCWC's will. Such a forced (and ex post facto) dedication by the CPUC effects a taking of SCWC's private water rights and is unlawful and a violation of the United States constitution.

Because the extent of dedication of SCWC's water rights was defined by its affirmative, unequivocal and voluntary actions, SCWC cannot be compelled to broaden the scope of

its dedication to its unused, surplus water rights. Thus, the CPUC clearly erred in ruling that SCWC had dedicated its 5,000 AFY in surplus water rights to the public use. The CPUC's order takes 5,000 AFY of SCWC's water rights without just compensation. Decision 04-03-039 is unconstitutional and should not stand.

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

F. CURT KIRSCHNER, JR.
(Counsel of Record)
PATRICIA A. SCHMIEGE
O'MELVENY & MYERS LLP
Embarcadero Center West
275 Battery Street, 26th Floor
San Francisco, CA 94111
(415) 984-8700

Attorneys for Petitioner

APPENDIX

APPENDIX A

Decision 04-03-039 March 16, 2004

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SOUTHERN CALIFORNIA WATER COMPANY (U 133-W), for an order authorizing it to increase rates for water service by $19,826,100 or 29.72% in the year 2003; by $6,327,800 or 7.31% in the year 2004; and by $6,326,200 or 6.81% in the year 2005 in its Region III Service Area and to increase rates for the General Office Allocation in all of its Customer Service Areas in this Application including: Arden-Cordova, Bay Point, Clearlake, Los Osos, Ojai, Santa Maria, Simi Valley and Metropolitan.	Application 02-11-007 (Filed November 4, 2002)

OPINION RESOLVING APPLICATION

TABLE OF CONTENTS

Title	Page
OPINION RESOLVING APPLICATION	1
1. Summary	5
2. Background	6
2.1. Procedural History	6
2.2. SCWC's Request	9
2.3. ORA's Recommendation	10
2.4. Position of the City of Claremont	11
2.5. Position of the City of San Dimas	11
2.6. Position of WPOA	11
3. Stipulation	11
3.1. Plant	13
3.2. Sales	20
3.3. Labor	21
3.4. Administrative and General (A&G) Expenses	21
3.5. Operation and Maintenance	22
3.6. Supply	23
3.7. Common Issues	24
3.8. Audit	25
3.9. Other Issues	25
3.10. Tariff Rules	25
POLICY ISSUES	26
4. Regional or Single Tariff Rates	26
4.1. Background	26
4.2. Discussion	27
5. Allocation of GO Costs to Non-GRC Districts	31
6. Allocation of GO and Other Costs to Unregulated Operations	32
6.1. Discussion	33
7. Cash Preservation Plan	36
7.1. Background	37
7.2. Discussion	38

TABLE OF CONTENTS
(Continued)

Title		Page
8.	Earnings Test	43
9.	Attrition	44
	9.1. Discussion	45
10.	Water Quality Memorandum Accounts	45
	10.1. Discussion	47
11.	Water OII Amortization	48
12.	Water Quality Compliance	49
13.	Lease of Water Rights to the City of Folsom	49
	13.1. Procedural Background	50
	13.2. Factual Background	51
	13.3. Discussion	53
COST OF SERVICE ISSUES		72
14.	Cost of Capital	72
	14.1. Cost of Debt	72
	14.2. Return on Equity	74
	14.3. Return on Equity – Discussion of Models	76
	14.4. Return on Equity – Discussion of Risk	80
15.	Sales	85
	15.1. Discussion	85
16.	Water Supply Mix	87
	16.1. Discussion	88
17.	Supply Cost Increases	89
	17.1. Discussion	89
18.	General Office Labor	90
	18.1. Discussion	90
19.	Security Plan	93
	19.1. Discussion	94
20.	Customer Information System Software	96
	20.1. Discussion	97

TABLE OF CONTENTS
(Continued)

Title	Page
21. Pensions and Benefits	98
21.1. Discussion	99
22. Reconnection Fees	100
23. Comments on Proposed Decision	102
23.1. SCWC Comments	102
23.2. ORA Comments	109
23.3. City of Claremont Comments	109
24. Comments on Alternate Proposed Decision	110
25. Assignment of Proceeding	112
26. Timing	112
Findings of Fact	113
Conclusions of Law	120
ORDER	127

OPINION RESOLVING APPLICATION

1. Summary

This decision grants Southern California Water Company (SCWC) authority to increase rates by $8,097,000, or 12.06% in the year 2003; by $1,891,600 or 2.50% in the year 2004; and by $2,789,100 or 3.60% in the year 2005 in its Region III Service Area. Rates for Region III will continue to be determined on a regional, rather than district specific, basis. SCWC's request to also increase rates for the General Office Allocation to customer service areas (CSAs) in Regions I and II is denied. We find that SCWC violated Public Utilities Code Section 851 when it failed to seek the Commission's approval for its lease of water rights to the City of Folsom. We fine SCWC $1,095,000 for this violation, but suspend $915,000 of the fine amount, for a net fine of $180,000. We require that 70% of prior revenues from the lease, plus interest, be reflected as a credit to future rates. The following table summarizes the authorized rate increases for Region III.

District	2003		2004		2005	
Region III						
Orange	$4,647,200	17.69%	$ 899,300	2.89%	$ 1,198,800	3.75 %
Claremont	520,800	4.83%	332,700	2.93%	438,900	3.75 %
San Dimas	1,021,400	7.90%	145,500	1.04%	530,700	3.76 %
San Gabriel	720,000	11.40%	332,300	4.71%	276,900	3.75 %
Barstow	1,187,800	17.80%	84,300	1.07%	311,100	3.93 %
Calipatria-Niland	-	0.00%	97,500	9.17%	32,700	3.93 %
Desert	-	0.00%	-	0.00%	-	0.00 %

Wrightwood	-	0.00%	-	0.00%	-	0.00 %
Total Region III	$8,097,000	12.06%	$1,891,600	2.50%	$2,789,100	3.60 %

2. Background

2.1 Procedural History

SCWC filed this general rate case (GRC) application pursuant to Pub. Util. Code § 454,[1] which governs proposed rate changes. The company requests Commission authorization to increase rates in its Region III Customer Service Areas, which include Orange County, Claremont, San Dimas, San Gabriel Valley, Barstow, Calipatria-Niland, Desert and Wrightwood. In addition, SCWC requested authority to increase current authorized revenues for the General Office for certain other CSAs that are not in for a GRC at this time.

The Office of Ratepayer Advocates (ORA) and the Orcutt Area Advisory Group filed protests to the application. Also, the Cities of Claremont and San Dimas sent a joint letter, to the assigned administrative law judge (ALJ) for this proceeding, indicating their opposition to the rate increases. A Prehearing Conference (PHC) was held on January 31, 2002. SCWC, ORA and the City of Claremont filed appearances.

---

[1] Unless indicated otherwise, all statutory citations are to the Public Utilities Code.

The Assigned Commissioner's Scoping Memo and Ruling was issued on February 28, 2003. That ruling set forth the scope, schedule, category, assignment of the principal hearing officer and ex parte communications rules for this proceeding, pursuant to Rule 6.3 of the Commission's Rules of Practice and Procedure (Rules).

On March 21, 2003, an ALJ ruling granted the requests of the City of San Dimas and the City of Ojai to intervene as interested parties. A similar request by the Wrightwood Property Owners Association (WPOA) was granted in a March 28, 2003 ruling.

On April 8, 2003, ORA, the City of Claremont, the City of San Dimas and the WPOA issued testimony addressing SCWC's request.

Public participation hearings (PPHs) were held the morning and evening of April 28, 2003, in Claremont and the afternoons and evenings of April 29, 2003, in Stanton and April 30, 2003, in Barstow. Approximately 400 ratepayers attended the two Claremont hearings, with 45 persons speaking. In afternoon and evening sessions, there were approximately 20 attendees in Stanton, with eight speaking, and approximately 50 ratepayers attending in Barstow, with 12 speaking. The Cities of Claremont and San Dimas participated at the Claremont hearings, while representatives of WPOA spoke at the afternoon session in Barstow.

The participation of public speakers was wide and varied. Mayors, city council members, chamber of commerce representatives, members and leaders of a number of civic groups as well as individual ratepayers representing themselves made their views known. At Claremont, the ALJ was presented with a petition signed by approximately 600

citizens, who opposed the proposed increases. At the Claremont and Stanton hearings, discussion focused on the comparison of rates for neighboring cities and water companies. In Barstow, water quality was a principal issue. In all three PPHs, the issue of regional, as opposed to district specific, rates was discussed. The proportionally high nature of the service charges[2] and the plight of senior citizens and low-income residents were also central themes.

On May 1, 2003, SCWC issued rebuttal testimony. An evidentiary hearing on the application was conducted over five days beginning on May 12, 2003. The company, ORA, the City of Claremont, and the City of San Dimas presented witnesses. Opening briefs were filed on June 16, 2003 and reply briefs on June 30, 2003. SCWC and ORA were the only parties that participated in the briefing.

On June 11, 2003, the Commission's Water Division issued its Report on Southern California Water Company's Regionalization of Rates in Region III.[3] On July 8, 2003, comments on the Water Division report were filed by

---

[2] Related to the high service charge issue, there were ratepayer complaints about the effect of local requirements to install sprinkler systems in houses for fire protection. Because of the sprinkler systems, larger service meters are required, and the monthly service charges for those larger meters are significantly higher than for meters that would normally serve the residences. Both the company and ORA indicated there were rate design options that would mitigate that effect.

[3] D.00-06-075, Ordering Paragraph 5, in part, directed the Water Division "to monitor the impact of single tariff pricing and report to the Commission in the next general rate case for SCWC's Region III with any recommendations for change in this pricing mechanism."

SCWC, ORA, the City of San Dimas and the City of Claremont. This matter was deemed submitted for decision as of that date.

Additionally, hearing was held on June 17, 2003 to consider a proposed joint SCWC/ORA stipulation exhibit. A motion to accept the Stipulation was then filed by SCWC/ORA on July 14, 2003. No comments were received.

2.2 SCWC's Request

Following is a summary of SCWC's requested rate increase, as reflected in its application.

District	2003		2004		2005	
Region III						
Orange	$7,953,900	30.39%	$4,579,300	13.39%	$2,786,400	7.19 %
Claremont	3,279,200	30.47%	156,100	1.11%	1,008,400	7.09 %
San Dimas	4,082,000	31.92%	165,100	0.98%	1,209,800	7.10 %
San Gabriel	2,266,000	36.02%	406,300	4.77%	648,500	7.26 %
Barstow	1,978,600	29.99%	1,032,900	12.14%	612,600	6.42 %
Calipatria-Niland	266,000	25.57%	5,800	0.44%	62,500	4.76 %
Desert	-		-		-	
Wrightwood	-		-		-	
Total Region III	19,825,700	29.79%	6,345,500	7.31%	6,328,200	6.81 %
Arden-Cordova	732,743	10.71%	301,625	3.98%	301,625	3.83 %
Bay Point	140,995	2.94%	68,972	1.40%	68,972	1.38 %
Clearlake	46,200	3.38%	22,648	1.60%	22,648	1.58 %
Los Osos	91,957	4.67%	42,207	2.05%	42,207	2.01 %

Metropolitan	4,055,241	5.32%	1,851,958	2.31%	1,851,958	2.25 %
Ojai	108,092	4.35%	54,560	2.10%	54,560	2.06 %
Santa Maria	358,913	5.57%	169,857	2.50%	169,857	2.43 %
Simi Valley	422,421	5.31%	195,078	2.33%	195,078	2.27 %
Total Company	25,782,662	14.75%	9,034,705	5.86%	9,033,105	5.49 %

2.3 ORA's Recommendation

Following is a summary of ORA's recommended rate increase as modified by the errata contained in Exhibit 52, dated June 1, 2003.

District	2003		2004	
Region III				
Orange	$ (929,000)	-3.50%	$ 124,111	0.48%
Claremont	472,800	4.29%	$ 337,894	2.92%
San Dimas	(277,100)	-2.08%	$ 403,384	3.08%
San Gabriel	(279,900)	-4.30%	$ 139,362	2.23%
Barstow	283,300	4.10%	$ (65,894)	-0.92%
Calipatria-Niland	419,500	37.47%	$ 174,555	11.17%
Desert	721,600	41.10%	$ 227,598	9.08%
Wrightwood	258,000	18.76%	$ 72,199	4.39%
Total Region III	669,200	0.98%	1,413,210	2.05%

In its testimony, ORA recommended that rates be determined on a district specific basis rather than the current regional basis. Additionally, ORA recommended that SCWC's request for an incremental general office increase

for Regions I and II be rejected. ORA supports an attrition increase for 2005, based on its recommended attrition mechanism, but did not quantify that amount.

2.4 Position of the City of Claremont

The City of Claremont recommended that the Commission reject SCWC's application to increase rates. The concerns expressed included the high rates of the Claremont CSA compared to that charged by agencies providing water in neighboring communities, SCWC's history of significant rate increase requests and the subsidizations caused by regional rates.

2.5 Position of the City of San Dimas

The City of San Dimas opposed the rate increases proposed by SCWC. The concerns highlighted were the proposed return on equity and regional rates.

2.6 Position of WPOA

WPOA supported the continuation of the single tariff rate structure that was authorized by the Commission for Region III in 2000.

3. Stipulation

SCWC and ORA filed a motion on July 14, 2003, requesting that the Commission adopt a proposed stipulation (Stipulation) that would resolve many, but not all, of the issues in this case. The following is a summary of the Stipulation.

Region III	SCWC Pre-Stipulation	SCWC Stipulation	Remaining Difference	ORA Stipulation	ORA Pre-Stipulation
2003					
At Proposed Rates	$ 86,542,200	$ 80,273,000	$ 6,698,400	$ 73,574,600	$ 69,242,000
At Present Rates	66,717,900	67,156,900	(1,200,200)	68,357,100	68,572,300
Increase	19,824,300	13,116,100	7,898,600	5,217,500	669,700
2004					
At Proposed Rates	$ 92,881,300	$ 83,716,200	$ 7,760,900	$ 75,955,300	$ 71,038,500
At Present Rates	66,724,400	67,472,400	(1,204,500)	68,676,900	68,945,700
Increase	26,156,900	16,243,800	8,965,400	7,278,400	2,092,800

The Stipulation is attached to this decision as Appendix I. We have reviewed that document along with the supporting appendices and conclude that the proposal to subject 51 capital projects to advice letter filings should be rejected. Rather than adopting the advice letter proposal, we estimate that $4,643,230 of plant additions will go into service, on average, beginning January 1, 2005. We estimate the revenue requirement effect to be $758,700 and will include that amount in the 2005 attrition year increase. SCWC is also authorized to file a separate application for recovery of the Calipatria treatment plant costs, or in the alternative may include the costs for review in the next GRC. Also, our resolution of issues related to SCWC's Cash Preservation Plan precludes the adoption of the maintenance expense portion of the Stipulation.

3.1 Plant

The following table shows SCWC and ORA estimates of plant additions before and after the Stipulation, as well as the remaining contested differences.[4]

Gross Plant Additions

	2002	2003	2004	3 Year Total
Before Stipulation				
SCWC	$16,923,560	$49,075,403	$31,241,380	$97,240,343
ORA	4,163,310	25,802,258	16,117,833	46,083,401
Difference	$12,760,250	$23,273,145	$15,123,547	$51,156,942
Stipulation				
GRC Budget	$ 4,390,253	$20,481,233	$15,819,913	$40,691,399
Advice Letter	460,600	14,190,922	7,479,466	22,130,988
Total Stipulation	$ 4,850,853	$34,672,155	$23,299,379	$62,822,387
Contested	$ -	$15,250,193	$ 5,412,500	$20,662,693

The table indicates that much of the original difference between SCWC and ORA was for projects that would, under terms of the Stipulation, be subject to advice letter filings. In its testimony, ORA recommended such treatment for a number of projects, resulting in much of the original revenue

[4] All data derive from the Stipulation, Section 2.00. Data reflect a stipulated 22.5% overhead as opposed to the 25% as originally filed by SCWC.

requirement difference with SCWC. ORA and SCWC have agreed that while there may be a need to undertake 51 individual projects, the timing, scope or estimates of cost are questionable. The parties would rather subject these projects to advice letter procedures than have these projects included in rates on an estimated test year basis. Fifteen projects relate to conservation expenditures, which ORA asserts are uncertain, due to prior SCWC deferrals in this area. Thirteen other projects relate to water supply items such as wells and reservoirs. Both SCWC and ORA made estimates for the Calipatria treatment plant but now agree to subject the related 23 individual projects to advice letter treatment after actual contractor bids of $13.2 million and $18.9 million far exceeded SCWC's original estimate of approximately $9.2 million. For this GRC, the parties propose advice letter treatment for the Calipatria treatment plant projects to be capped at $10.3 million, with any additional costs to be included in the next GRC.

We are concerned with the implementation of the Stipulation as it relates to the advice letter filings. The number of rate changes that will result from the proposal is not clear. Under Section 2.04 of the Stipulation, "ORA and SCWC agreed that SCWC is authorized to file advice letters seeking authorization to include in rate base, upon completion, the actual costs of the plant additions set forth herein and to receive a corresponding rate adjustment for the additional rate base." It could be interpreted that SCWC would be authorized to make as many as 51 advice letter filings, each with an associated rate change over the remainder of this rate case cycle. Since, as discussed further in this decision, we are maintaining regional rates, consideration of each of those rate changes would have to be

given to each of the districts in Region III. Not only would this proposal place a burden on the Commission staff in evaluating and processing the filings, but it would also be extremely confusing to customers

The magnitude of dollars that are to be subject to advice letter filings under the stipulated agreement is substantial. Advice letter projects represent approximately 25% of the total plant additions now being considered for the years 2002- 2004. Depending on the timing of the additions, the $22 million related to advice letter projects could generate a further annual increase of as much as $3 million to $4 million, or approximately another 5% over the rate case cycle.

Advice letter filings for capital projects are appropriate for large projects that do not occur regularly and where the timing is at issue. The necessity, scope and cost of the project would be defined and an advice letter review would have specific parameters to verify before the implementation of a rate change. In total the Calipatria treatment plant project is a large project and timing is certainly an issue. However, the cost and subsequently the scope of the project are uncertain due to the disparate cost estimates as described above. Advice letter verification of reasonable costs is therefore problematical. We note that a similar project was considered in the test year 2000 GRC[5] and was afforded advice letter treatment. We stated:

---

[5] See D.00-06-074 in A.99-05-035, et al.

> "For the Calipatria-Niland District, major plant additions are required to meet the Enhanced Surface Water Treatment Rules as determined by EPA and DHS. These rules are currently in effect. SCWC proposes that the $ 2.6 million cost be spread over the years 2000, 2001, and 2002. Because the costs of plant additions to comply with these rules are certain, rather than require SCWC to file a separate application as required for the proposed radon and arsenic facilities, we will adopt the recommendation of the stipulation that these costs be recovered through an Advice Letter. In the meantime, these costs should be accrued in a memorandum account, with carrying costs computed using the authorized rate of return, without gross-up for taxes."[6]

This project was apparently not done and the current treatment plant project is being proposed. However in the current case, the costs of plant additions are not certain. It is therefore reasonable to consider cost recovery for the project in a separate application, rather than through advice letter. In the alternative, SCWC can include the recorded costs in the next GRC. In either case, the company must justify the recorded expenditures and, given the disparate cost estimates, address its consideration of alternatives to the proposed project, or aspects of the project, in order to

---

[6] D.00-06-074, 2000 Cal. PUC LEXIS 345

mitigate the financial impacts. As before, we will allow SCWC to accrue the costs in a memorandum account, with carrying costs computed using the authorized rate of return, without gross-up for taxes.

The proposed advice letter proposal results in after-the-fact cost recovery for capital projects on a recorded cost basis, which conflicts with the idea of test year ratemaking where reasoned estimates are the basis for rate recovery and where, at least for the rate case period, certain shareholder/ratepayer risks are associated with potential over-spending or under-spending of adopted test year amounts. From this standpoint it is not appropriate to include normal projects that should be handled on an estimated test year basis, through advice letter filings. SCWC's conservation, well replacement, reservoir and "manganese filter, crooks" projects fall into this category. Rather than subject these projects to the proposed advice letter process, we will include appropriate costs in the estimates for this GRC, based on the record of this proceeding. Testimony and rebuttal testimony by all parties were prepared and received into evidence during evidentiary hearings. The need for the "manganese filters, crooks", for the Barstow CSA, was not discussed or justified by either SCWC or ORA; and we will not authorize recovery in this GRC. Estimates for replacement well, reservoir and conservation projects are discussed below.

Well replacement projects total $6,172,146. Many of the wells are nearing the end of their useful life and in order to minimize purchases of imported water, SCWC planned to begin a program to construct replacement wells.

For the San Gabriel well, ORA indicates that with no action the total remaining capacity of all the wells in this CSA would still be 98% of current capacity, the loss of only 2% of well capacity would not impact SCWC's operation adversely. The immediate need for this well is therefore at issue. The record does not substantiate such need, and we will not authorize cost recovery in this GRC cycle.

For the Lucerne Valley well, ORA indicates that SCWC is scheduled to build a reservoir in 2004 to assist the Lucerne Valley area in meeting fire flow requirements and maximum peak demand and there is no urgency to build this well in the same year. ORA recommends that it be deferred to 2005. SCWC did not rebut this recommendation.

For the remaining 7 wells, the issue is mainly one of cost. For the San Dimas well, two Orange County wells and two Claremont wells, ORA indicates that the estimates were considerably higher than similar projects completed recently and that SCWC did not have firm contractor quotes or bids to support the estimates. ORA did not provide an estimate of the costs but recommended advice letter treatment. For the two Barstow wells, ORA's testimony states that SCWC's increase is high especially since SCWC presented no evidence to justify its 2003 estimate. Based on its analysis, ORA estimated well replacement costs of $217,317 for 2003 and $225,676 for 2004 (in total, 63.7% of SCWC's estimate) but recommended the advice letter process due to future uncertainties. SCWC did not rebut ORA's criticism of the cost estimates. Also, the record does not include any justification by SCWC for its cost estimates. With no better information on which to rely, we will apply an adjustment factor of 63.7%, based on ORA's adjustments to the Barstow wells, to SCWC's estimate for each of the 8 well projects,

including the Lucerne Valley well, resulting in plant additions totaling $3,517,230. We assume, on average, the wells will be operational at the beginning of 2005 and will include the revenue requirement in the attrition year allowance.

Reservoir projects total $2,503,810. The Orange County reservoir site is needed to comply with MWD regulations requiring water agencies to purchase water at a constant rate each 24 hours. Two reservoir projects in Barstow are recommended as part of a master plan for the Barstow system.

For the Orange County reservoir, ORA indicates that the purchase of the land has not been finalized and that SCWC indicated that the project might be delayed to 2006. The immediate need for this reservoir is therefore at issue. The record does not substantiate such need, and we will not authorize cost recovery in this GRC cycle.

For the two Barstow reservoirs, ORA's testimony stated that SCWC's estimates are high especially since SCWC did not present ORA with cost breakdowns of its estimates. Based on its analysis, ORA estimated reservoir costs of $521,000 for 2003 and $605,000 for 2004 but recommended the advice letter process due to future uncertainties. SCWC did not rebut ORA's criticism of its cost estimates. We will use ORA's cost estimate in 2004 dollars as an estimate for the Barstow reservoirs, resulting in plant additions totaling $1,130,000. We assume, on average, the reservoirs will be operational at the beginning of 2005 and will include a full year's revenue requirement in the attrition year allowance.

Conservation projects total $2,763,042. The Urban Water Management Plan identified water conservation, as a

cost effective element of meeting water supply requirements, and this budget item is intended to carry out the conservation projects identified in that plan. However, there is no indication of what the individual projects and associated costs are or of any cost effectiveness analysis being performed. ORA indicates that SCWC had budgeted but not spent any money on conservation projects in 2002 and the timing and costs of the projects for 2003 and 2004 were uncertain. There is insufficient information to determine the reasonableness of a conservation project budget and we will not authorize cost recovery in this GRC cycle.

3.2 Sales

Section 3.00 of the Stipulation deals with sales to customers and addresses estimates of the number of customer connections as well as sales per customer. Estimates for each were made on an individual district basis, by customer class. In total, SCWC estimated the number of Region III customer connections to be 95,675 for 2003 and 96,118 for 2004, while ORA estimated 95,936 for 2003 and 96,476 for 2004. The stipulated amounts, which total 95,776 for 2003 and 96,237 for 2004, are a reasonable resolution of the differences between the two parties.

The estimates of sales per customer for the largest customer class, commercial, remain contested in this proceeding. The Stipulation does address the sales/customer differences for the other customer classes on a district basis. For those items, we find that the stipulated values, which are a mixture of the utility estimates, the staff estimates and values in between, reasonably resolve the differences.

3.3 Labor

Section 4.00 of the Stipulation resolves differences in the estimates of district labor, while general office labor remains a contested issue. The estimates of district labor were made on an individual district basis and include district O&M, allocated district office and allocated regional office labor costs. For 2003, SCWC estimated total district labor to be $7,536,800, while ORA estimated the amount to be $6,313,100. The stipulated expense total is $6,941,300. Similarly, for 2004, SCWC estimated $7,878,200, ORA estimated $6,485,200 and the stipulated total amount is $7,100,900. A portion of the district labor costs relates to maintenance expense, which we modify later in this decision when resolving issues related to SCWC's Cash Preservation Plan. For the remainder of district labor costs, the stipulated amounts appear reasonable and will be adopted.

3.4 Administrative and General (A&G) Expenses

As detailed in the Stipulation, Section 5.00, agreement was reached in the areas of office supplies, property insurance, injuries and damages (general office), injuries and damages (Region III CSAs), pensions and benefits (Region III CSAs), meals, regulatory commission expense, outside services, miscellaneous expenses, other maintenance of general plant, rent and capitalized A&G expenses. Based on the record in this proceeding, the stipulations related to A&G expenses appear reasonable and will be adopted. Also, for the allocation of costs related to the general office, common customer accounts and the region and district offices, the ORA and SCWC agree to use the updated "Revised Four-Factor" proposed by SCWC. The allocation percentages

contained in the Stipulation will be adopted. Pensions and benefits for the general office was not resolved as part of the Stipulation and is discussed later.

3.5 Operation and Maintenance

From information shown in Section 6.02 of the Stipulation, for 2003, SCWC estimated total other operations expense for the Region III districts, district offices and region office to be $1,543,000, while ORA estimated the amount to $1,248,300. The stipulated expenses for this category total $1,413,300. Similarly, for 2004, SCWC estimated $1,578,600, ORA estimated $1,278,700 and the stipulated amount is $1,542,800. For 2004, the fact that SCWC and ORA agree that an additional $100,000 should be added for uranium removal costs explains why the 2004 stipulated amount is much closer to SCWC's original estimate as opposed to that of ORA. In that light, the stipulations related to other operations expense appear reasonable and will be adopted.

Section 6.03 addresses other operating expenses in the general office, excluding those related to the contested issue of SCWC's proposed Security Plan. We will adopt the stipulated portions of the forecasts, which are very close to ORA's estimates.

From information shown in Section 6.04 of the Stipulation, for 2003, SCWC estimated total other maintenance expense for the Region III districts to be $3,452,400, while ORA estimated the amount to be $2,081,600. The stipulated expenses for this category total $2,550,100. Similarly, for 2004, SCWC estimated $3,581,600, ORA estimated $2,134,900 and the stipulated amount is $2,603,200. Other maintenance expense relates to

our resolution of the Cash Preservation Plan issue discussed later. We will therefore not adopt the stipulated amounts for other maintenance expense.

Sections 6.05 and 6.06 of the Stipulation resolve general office common customer account expense estimates (excluding labor) and general office postage reasonably. There was little difference in the ORA and SCWC estimates of common customer account expense and the stipulation for postage appears to reflect SCWC's zero-based budget and therefore the most recent postage rates.

Sections 6.01, 6.07, 6.08 and 6.09 of the Stipulation include percentage factors that ORA and SCWC have agreed to use for uncollectibles, property taxes, payroll taxes and local taxes. Based on the record, those factors appear reasonable and will be adopted.

3.6 Supply

Section 7.00 of the Stipulation relates to water supply issues, with Section 7.01 specifically addressing source issues. The percentage of water supply derived from wells and from purchases was disputed in five of the eight districts. ORA and SCWC stipulate to supply mix ratios for four of those districts with only that for the Claremont District remaining contested. The stipulations related to sources of supply appear reasonable and will be adopted.

Section 7.02 of the Stipulation itemizes stipulated and contested supply volumes by customer class for each of the CSAs. Supply volumes are a direct result of the number of customer connections and sales per customer. As discussed above, the issue of sales per customer for the commercial class remains contested. Therefore, the Stipulation leaves

the supply volume for that class unresolved. For the other classes, the numbers of customer connections and the sales per customer have been agreed to in Section 3.00 of the Stipulation, which we adopt. We therefore adopt the resultant supply volumes as shown in Section 7.02.

Supply volumes, unaccounted for water and supply mix ratios affect the supply issues described in Section 7.03 of the Stipulation. For expenses related to purchased water, purchased energy and pump taxes, ORA and SCWC agree on a procedure that uses the latest available rates prior to producing the final decision tables for 2003, as referenced in Section 8.03 of the Stipulation. We adopt the stipulated procedures for 2003. A procedure for 2004 remains unresolved by the Stipulation, since SCWC proposes to inflate the latest available rates to 2004 levels, while ORA proposes to exclude such inflation.

In Section 7.05 of the Stipulation, ORA and SCWC agree on a procedure to use SCWC's chemical unit cost per KCcf, to forecast chemical costs. Differences between their estimates of such costs are attributable to differences in estimates of sales and supply mix. We will incorporate the stipulated procedure in calculating adopted chemical costs in this decision.

In Section 7.05 of the Stipulation, ORA and SCWC agree to a procedure for determining unaccounted for water and water used in operations. For determining those quantities in this decision, we will incorporate the stipulated percentages.

3.7 Common Issues

Besides the procedure for determining rates charged for purchased water, purchased energy and pump tax, as

discussed above, Section 8.00 relates to inflation factors. The use of the latest available information and a 60/40 split between the non-labor index and the compensation per hour index are reasonable and will be incorporated in determining inflation for this decision.

3.8 Audit

Section 9.00 of the Stipulation resolves issues identified in ORA's audit of SCWC, as described in Exhibit 12. SCWC agrees with ORA recommendations regarding overhead construction costs, annual financial reporting and revenue from rental of water property, and ORA revises its recommendation regarding legal costs to reflect the end of litigation related to Barstow water rights. ORA and SCWC agree that $818,074 is properly accounted for in this GRC's rate base. Based on ORA's criticism of SCWC's determination of a construction overhead rate, ORA and SCWC have agreed on a rate of 22.5% to be applied to the general office and Region III capital budget components for the test year. These stipulations appear reasonable and will be adopted.

3.9 Other Issues

Section 10.00 of the Stipulation discusses the Water Quality OII expense amortization sought by SCWC. ORA has not stipulated to the amortization of these costs; however, so we will not consider this issue to be resolved by the Stipulation and will discuss it later.

3.10 Tariff Rules

Section 11.00 of the Stipulation addresses SCWC's proposed changes to the tariff rules. ORA agrees with proposals to modify the tariff conditions for the customer

deposit level, interest paid on customer deposits and the minimum diameter for private fire protection service. We will adopt those changes. One tariff issue related to reconnection fees remains contested.

POLICY ISSUES

4. Regional or Single Tariff Rates

ORA recommends that rates for Region III be determined for each of the districts in Region III based on a cost of service analysis for each of the districts. The Cities of San Dimas and Claremont support ORA's position for district specific rates. SCWC requests that the use of regional, or single tariff, rates be continued for its Region III. WPOA supports the company's position. This decision continues the use of regional rates, continues certain reporting requirements for SCWC and provides an opportunity for this issue to be addressed again in SCWC's next Region III GRC.

4.1 Background

At the request of SCWC in A.98-09-040, the Commission issued D.00-06-075, which established single tariff rates for Region III. The issue of single tariff (or regional) rates was controversial and in adopting SCWC's request, the Commission ordered the Water Division to monitor the impact of single tariff pricing and report in the next general rate case for SCWC's Region III with any recommendations for change. The current GRC proceeding for Region III is the proper proceeding for the Water Division to provide such recommendations.

Testimony by ORA and other interested parties was distributed on April 8, 2003. The advocacy function in water proceedings is now the responsibility of ORA rather than the

Water Division. ORA recommended that regional rates be discontinued in favor of district specific rates. SCWC issued rebuttal on this issue on May 1, 2003.

On June 10, 2003, the Water Division issued a separate report on the effects of single tariff rates in Region III, specifically in response to the direction given in D.00-06-075. While the report criticizes single tariff pricing as being advantageous to SCWC's shareholders and appears to question the motives of the company in making the request for regional rates, it indicates that more time is needed to make a comprehensive assessment. The report recommends that SCWC be ordered to continue to provide the Commission with an annual report as previously ordered in D.00-06-075, along with additional information on low-income customers, and that in the next GRC, SCWC should provide the Commission with a final report that includes justification for continuation of regional rates.

4.2 Discussion

In A.98-09-040, the issue of single tariff or regional rates for SCWC's Region III was raised and fully litigated. In granting the company's request for such rates, D.00-06-075 provides a full description of the process and fully justifies the actions taken therein. In this proceeding, we have not been presented with sufficient cause or justification for reverting to district specific rates.

The regional rate issue is a policy matter and from that perspective, there are compelling arguments for both continuing and terminating single tariff rates. While we agree with SCWC that this is a pricing rather costing issue, ORA arguments related to price signals, potential subsidies, customer input, etc. have merit. However, the arguments,

some of which were addressed in D.00-06-075, and the record in this case do not convince us to change our determinations that resulted in the establishment of regional rates. In D.00-06-075, we concluded that:

> "A region-wide tariff will benefit existing and future customers in SCWC's Region III by stabilizing rates, making rates more affordable in the smaller rate districts, and facilitating investment in water supply infrastructure and water treatment facilities." (Conclusion of Law 1.)

We stated that an overriding concern that favors single tariff pricing is the affordability of water in several of the small communities in Region III. That concern and our conclusion in that case are also relevant to this proceeding. For example, under the numbers generated by this decision for test year 2003, a stand-alone rate methodology would result in an approximate 47% increase in rates for the Calipatria – Niland District, while the overall average increase to the region is approximately 12%. The disparate affect on Calipatria – Niland is even more dramatic when considering the contemplated water treatment plant. If and when that facility is completed, at least an additional $10.3 million in rate base will be added to the Calipatria – Niland CSA, either in this GRC cycle by separate application or in the next GRC. The current rate base for this district is $2.7 million. New plant costs of $10.3 million could cause rates to increase by an additional 65% above the 2003 increase under district rates, while on a regional basis, average rates would increase by about 1.5%. On a district rate basis, the potential increase for the Calipatria – Niland CSA in this GRC cycle could therefore be as much as 160% when

considering the test year 2003 increase, the 2004 step increase, the 2005 attrition year increase and the potential treatment plant application.

Affordability is therefore a primary consideration in this proceeding as it was in A.98-09-040. SCWC has presented information showing that customers in certain high cost districts have benefited substantially from the regional rate structure with only a moderate effect on the subsidizing districts.[7] For instance, at the end of 2001, a customer in Morongo Valley who would have paid $83.49/month under stand alone rates for 10 Ccf, instead paid $47.02/month under regional rates. The subsidization by other districts can be seen in Orange County where customers who would have paid $22.81/month under stand-alone rates for 10 Ccf, instead paid $24.12/month under regional rates. Regarding the low-income rate program, which SCWC states can only be offered in Region III because single tariff pricing is in place, the low-income customer in Region III, on average, received an annual benefit of $42.60 or $3.55/month, which cost other Region III customers only $0.32/month.[8] From the aspect of affordability, regional rates appear to be functioning as anticipated in D.00-06-075. Since affordability continues to be a problem and regional rates can effectively address that problem, we will not alter the current rate structure as proposed by ORA and the City of San Dimas. Also, since we are affirming the viability of regional

---

[7] See SCWC, Conway, Exhibit 34, Table SLC-2.

[8] SCWC Conway, Exhibit 34 at pp. 19-20.

rates, we will not deny or defer this application as requested by the City of Claremont.

We re-emphasize that the decision, in A.98-09-040, to institute single tariff pricing in SCWC's Region III was largely policy based. It was understood that some districts would subsidize others and that the mix might change over time. It was understood that there were policy considerations and prior Commission practices that are not consistent with the idea of regional rates. However, along with the evidence presented in that proceeding, there were other policy considerations, especially that related to affordability, which persuaded us to grant SCWC's request. For essentially the same reasons, we have determined that it is reasonable to continue regional rates in this proceeding. At this point, we see no reason to require SCWC to further justify the existing rate structure in the next GRC as recommended by the Water Division. However, we recognize that there may be viable alternatives to regional rates and that subsequent investigation by others may provide a sound basis for altering the current rate structure. If so, any related decisions should be based on a comprehensive analysis and complete record.

For this reason we will require SCWC to continue to provide annual reports on regional rates as ordered and described in D.00-06-075. Those reports should be distributed to all appearances in this proceeding. In the next Region III GRC, parties may raise this issue again, but the burden will be on the parties to demonstrate why the rate structure should be altered as opposed to SCWC having to demonstrate why it should be continued.

In this proceeding, ORA raised specific concerns with the implementation and continuation of regional rates. While

ORA's concerns have sound theoretical bases, there is little evidence or analysis that substantiates the validity and applicability of those concerns specifically with respect to the Region III rate structure. For instance, if the data is available, the potential subsidization of high income ratepayers in high cost districts by low income ratepayers in low cost districts could be objectively analyzed and problems specific to Region III, if they exist, could be demonstrated. Similarly changes in usage patterns by subsidized users and the effect on utility efficiencies could be demonstrated with facts and objective analyses. Such analyses should be the foundation for any proposals to alter the current rate structure.

5. Allocation of GO Costs to Non-GRC Districts

SCWC requests that the General Office (GO) costs adopted in this Region III GRC be allocated to the Region III districts as well as to the non-GRC districts (those districts in Region I and Region II). For the non-GRC districts, SCWC proposes to increase rates only for the incremental allocation of GO costs above the level of GO costs already incorporated into their rates. ORA recommends that SCWC's request be denied because a GO adjustment for non-GRC districts would provide SCWC rate increases for the GO cost twice, GO costs require a thorough review beyond what is given offset costs, and the request goes against the rate case processing plan.

We conclude that SCWC's proposal should be denied. For the non-GRC districts, SCWC's showing neither details the embedded expenses and capital costs for the various test and attrition years, nor explains how such costs should be determined. Also, for capital costs estimated in this GRC,

the rate base amounts, net returns and income taxes related to GO plant additions are not separately identified from the non-GO amounts. We therefore cannot determine the reasonableness or accuracy of SCWC's incremental proposal. We will instead adopt ORA's recommendation that GO recovery should be determined in the GRC for each region. This methodology was used for SCWC, previous to the test year 2000 Region III settlement, and does not depend on incremental changes to GO expenses and capital costs.

6. Allocation of GO and Other Costs to Unregulated Operations

American States Water Company, the parent holding company for SCWC, provides services on an unregulated basis to third parties through its American States Utility Service Company (ASUS) subsidiary. According to SCWC's proposal, a portion of the revenues from the non-regulated operations of ASUS are shared with SCWC's ratepayers as "other revenues" to the utility operation. In its estimate of other operating revenues for Test Year 2003, SCWC includes $63,400, which represents the ratepayer share of revenues from non-regulated services provided by ASUS. SCWC states that its allocation of revenues from non-regulated services between ASUS and SCWC conforms to the methodology adopted by the Commission in D.00-07-018.[9]

---

[9] In that decision, the Commission adopted a revenue sharing proposal for non-regulated service revenues. Revenues from "active" services are allocated on a 10% ratepayers/90% shareholders (i.e., ASUS) basis. Revenues from "passive" activities are allocated on a 30%

Footnote continued on next page

ORA argues that D.00-07-018 does not apply to what SCWC and its unregulated affiliate are doing. In ORA's opinion, if ASUS bears its full share of overhead and common costs as determined by an impartial cost study, nothing more is needed. ORA requests that the Commission order a study to determine the full costs, both expense and capital, incurred by SCWC on behalf of ASUS, presently and in the future. Once completed, SCWC should develop either allocation factors for accounting transfers to the books and records of ASUS or a set of charges to be billed to ASUS and reimbursed to SCWC. Until the study is completed, ORA requests that the Commission suspend the affiliate revenue sharing procedure proposed by SCWC and has included an increase of $101,300 in GO revenues to reflect the suspension.

This decision concludes that SCWC should follow the policies and guidelines adopted in SCWC's holding company decision, D.98-06-068, regarding affiliate transactions. In order to reflect the principles, policies and guidelines outlined in D.98-06-068, SCWC is ordered to conduct a cost study and analysis that will be the basis for assigning and allocating future costs related to its affiliates. Until then, we will impute a revenue adjustment of $101,300.

6.1 Discussion

SCWC and ASUS are both subsidiaries of American States Water Company. In dealing with its affiliates, SCWC

---

ratepayers/70% shareholders basis. The designation of activities as either active or passive was shown on Table A attached to D.00-07-018.

should be following the procedures and reporting requirements adopted in D.98-06-068, the Commission decision that authorized SCWC to form a holding company structure. In justifying the formation of the holding company, the company stated:

> "SoCalWater foresees a variety of opportunities in unregulated businesses including, for example, public/private partnerships with municipalities and other local governmental agencies that could involve long-term lease concessions of water systems, operation and maintenance contracts, and billing and other customer service functions. It may provide such services to other Commission-regulated utilities as well. A holding company structure would separate the regulated utility and thus help insulate customers from these competitive and unregulated business activities without compromising the Commission's oversight and regulatory responsibilities. There would be fewer potential cross-subsidization issues, and SoCalWater would be better able to tailor its finances and organization to both roles. SoCalWater would continue to make appropriate allocations where, as now occurs from time to time, its personnel engage in both regulated and non-regulated activities, and those allocations would continue to be

subject to Commission review to protect ratepayers."[10]

The decision adopted specific policies and guidelines for the various transactions conducted between SCWC, the holding company and affiliates. The overriding theme is that ratepayers should not subsidize affiliate operations. The justification for allowing SCWC to establish the holding company structure and the implementation principles are directly applicable to the issue of allocating costs to unregulated operations in this GRC. SCWC should follow the policies and guidelines adopted in D.98-06-068.

Rather than following the principles and guidelines of the holding company settlement, SCWC has instead used the principles established in D.00-07-018, which established an Other Operating Revenue (OOR) sharing mechanism applicable to water utilities that intend to offer non-tariffed services. SCWC has misinterpreted the intent of that decision. The revenue sharing mechanism is intended to apply to a water utility (1) providing non-tariffed services, (2) sharing the gross revenues with ratepayers, and (3) absorbing all incremental costs. It does not apply to non-regulated affiliates of the water utility. While we regulate water utilities, we have no direct authority over non-regulated affiliates. Rather than imposing a sharing mechanism on the revenues of non-regulated affiliates, we instead attempt to ensure that utility and affiliate costs are properly separated and common costs are fairly allocated. In

---

[10] 80 CPUC 2d at 582.

that way, sharing of non-regulated affiliate revenues with ratepayers is unnecessary.

Since SCWC is relying on the revenue sharing mechanism adopted by D.00-07-018 to reflect the proper cost reimbursement by ASUS to SCWC, ASUS is only charged on an incremental cost basis. It is therefore apparent that a cost study and analysis, as recommended by ORA, is required in order to fairly assign and allocate costs related to SCWC's affiliates, in accordance with the principles, policies and guidelines outlined in D.98-06-068. We will order such a study to be completed by SCWC and included in its next Region III GRC application. The company must address each point in the holding company decision that applies to affiliate transactions and costs and must show the effect, on both affiliate and utility costs, of implementing the appropriate measures to comply with the terms of that decision. SCWC also must adopt appropriate management policies and accounting practices to ensure that the terms of the holding company decision are fully implemented.

ORA requests that the Commission suspend the affiliate revenue sharing procedure proposed by SCWC, until the cost study is implemented. ORA's adjustment amounts to an increase of $101,300 in GO revenues. We adopt ORA's adjustment but characterize it as a proxy for potential adjustments that might result from the cost study. Under the circumstances here, where the utility has apparently not been following procedures adopted in its holding company decision, the adjustment is reasonable.

7. Cash Preservation Plan

The Cash Preservation Plan (CPP), implemented by SCWC in early 2001, was designed to limit cash

expenditures on capital projects and O&M for its electric and water operations during the energy crisis. SCWC argues that both its capital and O&M budgets now need to reflect on-going operations, not artificially depressed levels attributable to extraordinary circumstances. SCWC states that the budgets in this application reflect return to normal operations.

ORA recommends that SCWC's revenue requirement be reduced by $3.6 million for O&M expenses not spent and $3.2 million for the carrying charge of the capital projects deferred during 2001 and 2002 over the next two years, since SCWC ratepayers were denied the benefit of funds that the Commission approved for those purposes. ORA does not argue that the CPP was unreasonable or unjustified but does oppose customers paying twice for the same O&M expenses and projects.

This decision imposes a reduction to Region III maintenance expenses in the amount of $352,000 for both test year 2003 and 2004. Without such an adjustment, shareholders will receive a windfall due to deferral of expenditures and recovery of electric energy costs through balancing account treatment.

7.1 Background

The CPP was implemented in response to a deterioration in SCWC's cash flow due to escalation in energy prices in California beginning in 2000. While the price of electric energy escalated dramatically, rates to SCWC's electric customers remained unchanged. As a result, SCWC substantially under-collected those costs through revenue and accrued those under-collected costs in a balancing account. Between December 1999 and June 2002, SCWC paid out

over $25 million more in electric power costs than was recovered in customer rates.

SCWC consciously made the decision to preserve cash intended for water operations in order to pay the electric bills of its Bear Valley Electric District (BVE). BVE customers, SCWC water customers and shareholders provided the cash for that purpose. Since the energy-related revenue shortfalls were afforded balancing account treatment, recovery of appropriate energy costs for BVE will be addressed in BVE proceedings and BVE customers will eventually pay for the 2001 and 2002 energy revenue shortfalls through whatever mechanism is adopted in the energy company proceedings.

The CPP included measures such as a hiring freeze, reductions in operating expenses, and elimination or deferral of all capital projects except for those projects that were considered essential either to meet public safety and health requirements or to provide continued service.[11]

7.2 Discussion

BVE purchased energy costs were in part paid by SCWC water customers. Through the balancing account procedure for costs incurred in 2001 and 2002, BVE will eventually be

---

[11] In its testimony, SCWC shows that in 2001 its capital budget was $52 million and actual capital expenses were $39 million. For 2002, the budget was $56 million and the recorded amount was approximately $45 million. In 2001 maintenance expenses on a company wide basis were $2 million less than budgeted. Also for the first 6 months of 2002, the gap between budgeted and recorded was $2 million, and as a part of the CPP, SCWC implemented a hiring freeze in 2001, holding the employee count at its February 2001 level.

made whole for the reasonable amount of purchased power costs. Water customers should therefore be reimbursed, in some manner, for the cash that was diverted from the water operations for those years. To do otherwise would result in a windfall for shareholders. This is explained below.

The BVE purchased energy costs were paid to energy providers during 2001 and 2002. The balancing account then tracked the money that would eventually be repaid to whoever put the money up at that time. As revenues are collected to offset the balancing account expenses, they will not be used to actually pay the purchased energy costs but to reimburse those who put up the money in 2001 and 2002. The cash to pay for the energy purchases in 2001 and 2002 came from three sources. First, cash was available from the BVE ratepayers, through electric rates at that time. Second, cash derived by deferring expenses and capital projects related to the water operations was used to offset a portion of the revenue shortfall. Third, cash to offset any remaining shortfall would have come from shareholder funds. Therefore, while the water operations and shareholders funded a portion of the revenue shortfall,[12] unless specific provisions are made, as money accrues to the balancing account to offset that portion of the shortfall, all of those revenues will accrue to shareholders. It is reasonable to return an appropriate amount as offsets to costs of the water operations.

---

[12] Electric customers also funded a portion of the shortfall through cash derived from deferred expenses and capital projects. The consequences, if any, should be addressed in BVE rate proceedings.

Since this GRC addresses rates for Region III only, we will only consider the effects of the CPP on Region III in this decision. Affected expenditures, as indicated by SCWC, include maintenance expenses, operating expenses, A&G expenses and capital related costs. Regarding capital costs, SCWC indicates that its general policy is to hold capital spending within Commission-adopted amounts, and that, based on its internal budgets, it deferred a substantial amount of capital expenditures in 2001 and 2002. Nevertheless, the recorded additions for those years are slightly higher than authorized in the previous GRC decision;[13] thus, it appears that, in this GRC, ratepayers are not paying for capital projects that were deferred from the last GRC.

This does not appear to be the case for O&M. The long-term effects of deferred spending, especially in the area of maintenance, are hard to quantify, but deferrals of necessary expenditures jeopardize the efficient operation of the utility's system and may result in higher long-term costs. For instance, the testimony of SCWC's District Managers indicates that over time the company has under spent for maintenance even though it generally spends what the Commission authorizes for such purposes,[14] that the deferral of maintenance expenditures could have certain long-term effects on the operation of the system, and that the proposed

---

[13] SCWC states that its internal capital budgets included $52 million for 2001 and $56 million for 2002. Recorded amounts were $39 million for 2001 and $45 million for 2002 while the authorized amounts were $37 million and $42 million, respectively.

[14] See transcript 438-433 Perry Dahlstrom.

GRC maintenance expense amounts include items deferred from previous years.[15]

In considering reimbursement for Region III, we will assume that the amount that should eventually flow back to those water ratepayers is the difference between what should have been spent for maintenance for 2001 and 2002 and what was actually recorded for those years. We could have based the adjustment on the difference between what was previously authorized and what was spent, but the record does not establish previously authorized amounts and we have some concern regarding deferred maintenance as discussed above. Recorded maintenance costs for Region III are listed below.

Region III Recorded Maintenance Expense

Year	Labor	Non Labor	Total
1997	$ 936,200	$1,608,200	$2,544,400
1998	1,030,000	1,934,800	2,964,800
1999	1,076,500	2,989,800	4,066,300
2000	1,131,300	2,657,700	3,789,000
2001	1,034,500	1,773,300	2,807,800
2002	1,122,100	2,185,700	3,307,800

To determine what should have been spent in 2001 and 2002 on maintenance, we assume the 2003 maintenance expense forecast of $3,689,000 that is included in the Stipulation is reasonable. We also assume that 2001 and

---

[15] See transcript 451-453 Patrick Scanlon.

2002 were not normal spending years due to the energy situation and that the amounts not spent in 2001 and 2002 were used to offset increased energy procurement costs for BVE customers. We also assume that a reasonable estimate of what would normally have been spent in 2001 (absent the energy crisis) is the 2003 stipulated amount deescalated to 2001 dollars, or $3,556,100. Similarly, a reasonable estimate for 2002 is the 2003 stipulated amount deescalated to 2002 dollars, or $3,616,200. When compared to recorded amounts, the difference is $748,300 for 2001 and $308,400 for 2002 or $1,056,600 in total. We will amortize that amount over this GRC cycle at $352,200 per year as a reduction to the ratepayers' obligation to fund maintenance expenses. The stipulated maintenance expenses will be funded partially by shareholders who will be receiving money to do so through the BVE balancing account recovery mechanisms. We will not make further adjustments for the apparent deferral of expenses related to operating expenses and A&G expenses. Of the three expense categories, maintenance has the largest deferral amount. Our adopted adjustment is not precise and we will assume that the result also covers operating and A&G deferrals.

SCWC claims that all deferred O&M expense projects will have been completed by the end of the current rate case cycle. However, if the "current rate case cycle" is the currently authorized 2000-2002 cycle, the record does not support that statement. Based on its own testimony, SCWC underspent in both 2001 and 2002. If the "current rate case cycle" is the 2003-2005 cycle being considered in this proceeding, we would have concerns about recovery of deferred maintenance in subsequent rate cases, as expressed in D.82-12-085 regarding a Southern California Edison

Company GRC.[16] In that decision, the Commission disallowed deferred maintenance costs for ratemaking purposes but did not relieve the company of its responsibility to maintain the operating efficiency of its utility plant in a timely manner. SCWC's claim regarding completion of deferred projects is not persuasive.

8. Earnings Test

For the earnings test used to justify step and attrition rate increases, ORA proposes a change whereby the weather-adjusted recorded sales per customer for Residential and Commercial customers would be used, instead of the adopted sales per customer, for the calculation of the revenues. ORA states that originally, the procedure was designed to normalize sales against sales changes due to weather variations. However, because of the difficulty and time involved in the weather normalization process, adopted sales quantity has been used and, in reality, weather normalization is not being done. Under ORA's proposal, when the utility is over-earning (the actual earnings are higher than the adopted earnings) because of inaccurate adopted sales, the step and attrition rate increases would be reduced or eliminated through the earnings test, protecting the ratepayers from unnecessary rate increases.

In response, SCWC asserts that under existing procedures, pro-forma revenues for residential and commercial customers are based on adopted sales per customer, not weather-adjusted recorded sales per customer,

---

[16] See 10 CPUC 2d at 184-186.

and that ORA's recommendation is inconsistent with long-standing procedures for the pro-forma earnings calculation. SCWC believes ORA is inappropriately attempting to use SCWC's GRC to implement changes to industry-wide policy.

This decision denies ORA's request and concludes that the issue would be more appropriately addressed in a generic proceeding where all affected utilities could participate.

9. Attrition

SCWC states that an unintended consequence of agreeing to advice letter procedures for certain capital projects, as reflected in the Stipulation, is that exclusion of the advice letter projects from authorized rate base negatively impacts the calculated attrition increase for 2005 by reducing the capital additions covered by the attrition increase. SCWC proposes that for the purpose of calculating the attrition year increase, the weighted average rate base for 2003 and 2004 should include advice letter projects.

ORA argues that SCWC's proposal would result in double recovery of the cost of those advice letter projects, once through the attrition rate increase, and again, through an advice letter rate increase. SCWC claims its proposal would not result in double recovery, but would simply allow SCWC to maintain in 2005 a level of capital improvements similar to that stipulated to for 2003 and 2004.

Due to the manner in which the proposed advice letter projects are considered in this decision, we will not adopt SCWC's proposal.

9.1 Discussion

By this decision, SCWC is authorized to accrue the costs of the Calipatria treatment plant project in a memorandum account and seek rate recovery either through a separate application or in the next GRC for Region III. This is a large project in the range of $10 million to 18 million. It is not reasonable to reflect its effect in the attrition calculation. Projects of this magnitude must be evaluated based on the need and costs of the particular project. Rate recovery should not be accomplished through the attrition mechanism.

By this decision, the remaining proposed advice letter projects are treated as normal plant additions and are estimated as such. Due to the uncertainty of the timing of the projects, this decision assumes that, on average, the operational date for the projects is January 1, 2005. An allowance for the attrition year is therefore already included for these projects.

10. Water Quality Memorandum Accounts

SCWC seeks memorandum account treatment for costs to comply with five specific water contaminants. The five contaminants are MTBE,[17] perchlorate, NDMA[18], radon, and arsenic. The water industry has seen a tremendous expansion in the number of water contaminants over the last 20 years, many of which have had a significant negative impact upon water supplies throughout California. The expense

---

[17] methyl tertiary butyl ether

[18] N-nitrosodimethylamine

associated with building new treatment facilities to comply with maximum contaminant levels (MCLs) adopted for emerging contaminants is high and can involve complex treatment methodologies and significant lead time (design, bidding, construction) prior to completion. SCWC states that, in the past, it has included costs associated with anticipated MCLs, but when these costs are included in capital and O&M budgets in applications, they have been rejected by ORA, because the MCLs are not final, or have a long compliance period and/or are subject to change.

ORA argues that SCWC's request for Water Quality Memorandum Account should be denied because SCWC is requesting blanket memorandum account, before specific rules become effective. Absent such rules, there would be uncertainty about which costs would be charged to the memorandum account. ORA recommends instead that SCWC be allowed to file an advice letter when such water quality rules become effective.

SCWC notes that when the Commission authorizes creation of a memorandum account, it only allows for the recordation of certain costs in that account. Before a utility can recover in rates the costs recorded in the account, the utility must demonstrate the reasonableness of the costs. SCWC indicates that its request is no different – it seeks only the creation of various water quality memorandum accounts, so that it may book, or record, its costs in those accounts. When SCWC seeks to recover the costs, it will apply to the Commission to do so, and will demonstrate the reasonableness of those costs.

We grant SCWC's request for memorandum account treatment for costs to comply with requirements related to the five specified contaminants.

10.1 Discussion

Costs to mitigate water contamination are difficult to forecast until the appropriate regulator specifies the associated requirements. The requirements determine both the magnitude and the timing of expenditures. Establishing such requirements is out of the utility's control, and a memorandum account procedure is a reasonable way to deal with the problem. We also agree with SCWC's characterization of the memorandum account procedure. We therefore authorize the account as requested by SCWC.

The related utility expenditures would include capital costs, O&M costs, monitoring costs, legal costs and consultant costs associated with activities to mitigate the effects of the five specified contaminants. The costs booked to the memorandum account must be the incremental capital costs and expenses. We emphasize incremental. The utility must be able to demonstrate that existing rates do not directly or indirectly already include consideration for the recovery of these costs. If they do, the utility must be able to show that appropriate consideration of those costs was given in determining what the incremental costs in the memorandum account should be. For instance, for arsenic, the MCL may be substantially reduced in the future. There may then be increased costs related to the tougher MCL requirements. Before the costs of any new program are recovered in rates through the memorandum account, the utility must demonstrate that the requested costs are truly incremental. They should be net of any previously recovered costs related

to the old MCL activities replaced or augmented by the new MCL activities. The utility should clearly describe in its preliminary statement which costs it plans to book.

We intend that ongoing costs eventually be reflected through the GRC process, at which time the accumulated balance and proposed recovery can be examined. Until then, the memorandum account would accumulate the associated costs.

11. Water OII Amortization

In 1998, the Commission issued Resolutions W-4089, W-4094 and W-4257, authorizing the establishment of memorandum accounts for the Water Quality OII (I.98-03-013) and water quality litigation expenses. While the water quality lawsuits are still active, a final decision in the OII was issued by the Commission on November 2, 2000. The Commission concluded that the California Department of Health Services requirements governing drinking water quality adequately protect public health and safety, and that regulated water utilities, including SCWC, have satisfactorily complied with past and present drinking water quality requirements. SCWC seeks in this proceeding to amortize the balance of the OII expenses. The current balance as of March 31, 2003 is $1,052,480 as shown in Schedule 4 of Exhibit 37.

SCWC seeks to amortize the Water Quality OII portion of the memorandum account through a special condition surcharge over a 12-month period, applied to the quantity rate throughout the company. Based on the current balance, the surcharges for each CSA are shown in Schedule 4 of Exhibit 37. ORA does not oppose SCWC's request, and we will grant it.

12. Water Quality Compliance

In Schedule 2 of Exhibit 31, SCWC has presented its water quality compliance record from March 1998 to December 2002, updating the data presented to the Commission in the Water Quality OII. SCWC seeks a finding from this Commission that it is in compliance with present drinking water standards and water quality regulations.

In its report for the update period, SCWC has provided instances of noncompliance with drinking water standards, instances the drinking water standards were exceeded, number of citations from the DHS, corrective measures taken to comply with regulations and corrective measures related to 10-day letters of compliance. However, whether this information is complete and accurate and whether it warrants a finding that SCWC remains in compliance with applicable drinking water standards and water quality regulations needs to be verified, preferably by the DHS. No such verification has been established in this proceeding. For this reason, we cannot make the finding as requested by SCWC.

13. Lease of Water Rights to the City of Folsom

In November 1994, SCWC signed a contract to lease, to the City of Folsom (Folsom), 5,000 acre-feet per year (AFY) of water rights to the American River and has included all associated revenues in a non-operating revenue account. The lease is for an indefinite period, and SCWC has no rights to terminate the lease. Staff asserts that SCWC was imprudent in signing the lease and was negligent in not filing an application under § 851 for Commission approval of the lease. Staff recommends the lease be voided, SCWC be fined $180,000, SCWC's rate of return be reduced by 50

basis points, lease proceeds be booked to an operating revenue account, all recorded lease proceeds from 1996 – 2003, plus interest, be credited to ratepayers and SCWC be ordered to file certain water supply and demand information. This decision finds that SCWC violated § 851 in failing to obtain Commission approval for the lease, voids the lease as to SCWC, and fines SCWC $1,095,000, of which $915,000 is suspended, for a net fine of $180,000. This decision further assigns all lease proceeds from the year 2004 forward to an operating revenue account and directs a credit to future rates equal to the total of prior lease revenues, plus interest. These changes will be used in the determination of the revenue requirement for the Arden-Cordova CSA.

13.1 Procedural Background

Issues related to the 1994 lease were raised by ORA in the test year 2001 GRC (A.00-03-064) for SCWC's Region I, which includes the Arden-Cordova CSA. In that proceeding, the Ratepayer Representation Branch (RRB) contended that SCWC violated § 851 when it entered into its 1994 agreement with the City of Folsom. Staff recommended that the Commission order SCWC to return all revenue collected from the leasing of water rights since 1994 to the customers and order SCWC to file an application requesting Commission authorization of the contract.[19] Subsequently, SCWC issued rebuttal testimony on this issue. RRB and SCWC eventually settled the GRC; and, as part of the settlement, the parties agreed to defer the lease issue to a

---

[19] See Exhibit 14-A, p. 7

proceeding in early 2001.[20] That proceeding was to be the GRC for Region II. The Region II GRC was not filed as anticipated at the time of the settlement. Instead, the next GRC filed by SCWC is the current Region III GRC. Therefore, ORA, the staff advocacy successor to RRB, has raised the lease issue in this proceeding, and SCWC has again rebutted the related staff testimony.

13.2 Factual Background

The facts contained in the following background discussion are not in dispute.

In June 1964, SCWC purchased the Natomas Water Company. With the purchase, SCWC obtained 32,000 acre-feet per year (AFY) of water rights to the American River. Subsequently, by D.71889 issued January 24, 1967, the Commission authorized SCWC to transfer the Folsom water system and 22,000 AFY to the City of Folsom

From 1966 to 1970, SCWC used approximately 500 AFY of raw, untreated water from the American River for irrigation customers in Rancho Cordova. SCWC had no facility to treat surface water after the City of Folsom acquired the Folsom Treatment Plant.

SCWC constructed the Coloma Treatment Plant (operational in 1973) to treat surface water. The plant and system that was recorded in SCWC's rate base could treat and distribute only 5,000 AFY of SCWC's entitlement to

---

[20] See Section 6.01 of the Settlement attached as Appendix B to D.00-12-063.

American River water. Attached as Exhibit B to Exhibit 38 is a chart detailing SCWC's actual surface water production from the American River from 1973 through 2002. The chart shows that SCWC's use of surface water from the American River was as low as 678 AF in 1973, gradually increasing to 3,451 AFY by 1990.

In November 1994 SCWC signed the lease with the City of Folsom. At that time, SCWC had never used more than 3,451 AFY of surface water from the American River to serve its customers. Lease revenues received by SCWC have been booked in PUC Account 526, Miscellaneous Non-Operating Revenues. Since this is a below-the-line account, all revenues have benefited shareholders.

In 1994, groundwater was plentiful and it was cheaper for customers to be supplied by groundwater than by American River surface water, which had to be treated at the Coloma Treatment Plant before it could be delivered to customers. At that time, it cost approximately $56.73 per acre-foot to deliver potable water from the Coloma Treatment Plant (American River surface water), compared to only $37.10 per acre-foot to deliver potable water from SCWC's groundwater wells in its Cordova system. The total power and chemical cost for the two sources of water is virtually identical, but the labor cost associated with operating the Coloma Treatment Plant made using surface water more expensive.

Also in the 1994 timeframe, while a few wells had begun to show traces of TCE[21] contamination, SCWC had successfully installed granulated activated carbon filters on the wells to remove TCEs. SCWC did not discover that there were detectable levels of perchlorate in its groundwater wells until 1997, and did not discover the presence of NDMA in its wells until 1998. All of SCWC's groundwater wells were fully operational until 1997, when the utility discovered the perchlorate contamination. Since 1997, SCWC has taken out of service 11 wells due to the contamination.

To address water supply problems, SCWC has placed into operation several new groundwater wells that were drilled in locations away from the contamination and has constructed new treatment capacity at its Coloma Treatment Plant. In the short term, SCWC plans on using 10,000 AFY of untreated water obtained in a "take or pay", five-year contract with the Sacramento Municipal Utilities District (SMUD). The contract became effective July 29, 2002.

13.3 Discussion

We address two important issues related to the lease. The first is whether SCWC should have filed an application, under § 851, to request Commission approval of the lease of 5,000 AFY of water rights to the City of Folsom, beginning in 1995. The second concerns the proper ratemaking

---

[21] Trichloroethylene

treatment for revenues received from the lease of the water rights.[22]

A. Did SCWC Violate § 851?

SCWC did not seek Commission approval under § 851 for what amounts to a lease in perpetuity of its right to 5,000 AFY of American River water. Section 851 provides in relevant part:

> No public utility . . . shall sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or any part of its railroad, street railroad, line, plant, system, or other property necessary or useful in the performance of its duties to the public . . . without first having secured from the commission an order authorizing it so to do. Every such sale, lease, assignment, mortgage, disposition, encumbrance, merger, or consolidation made other than in accordance with the order of the commission authorizing it is void. . . .
>
> Nothing in this section shall prevent the sale, lease, encumbrance or other disposition by any public utility of property which is not necessary or useful in the performance of its duties to the public, and any disposition of

---

[22] In light of our determination that SCWC violated § 851 and that the lease is therefore void, we do not reach a third issue addressed by the parties, the prudence of SCWC's decision to lease the water rights.

> property by a public utility shall be conclusively presumed to be of property which is not useful or necessary in the performance of its duties to the public, as to any purchaser, lessee or encumbrancer dealing with such property in good faith for value . . ..

SCWC contends that it was not required to seek § 851 approval for the lease because the portion of surface water rights that it leased was not "necessary or useful in the performance of its duties to the public". SCWC notes that, at the time it entered into the lease, it had never used more than 3,451 AFY of its total 10,000 AFY entitlement, had the capacity to treat only 5,000 AFY and did not anticipate a future need for the 5,000 AFY leased to Folsom. In support of its position that it was not required to file a § 851 application, SCWC relies on, among other decisions, D.82-12-021, in which the Commission declined to exercise § 851 jurisdiction over PG&E's sale of coal mine property,

We cannot agree with SCWC that it was free to bypass the § 851 review process for the lease in perpetuity of 50% of its rights to surface water that could potentially be used to serve its customers. Our conclusion is driven by the plain words of the statute, the purposes served by the § 851 approval process, and Commission decisions.

The plain words of § 851 do not support SCWC's position. The exclusion from Commission review set forth in the first sentence of the second paragraph only applies to property that is not necessary *or useful* in the performance of the utility's duties to the public. The word "useful" manifests clear legislative intent for the statute to apply not just to transactions involving property that is necessary for

utility service, but for a broader category of transactions involving property that is capable of being used to serve customers. While it is debatable whether at the time of the time of the lease, the portion of the water rights that were the subject of the 1994 lease were *necessary* for current or future needs, those water rights were certainly *useful* in providing a guaranteed source of supply in the event that other water supply sources became unavailable. In this sense, the water rights that were leased to Folsom were equivalent to an insurance policy that helped to guarantee that the utility would have the water supply necessary to meet its duties to the public. Even if claims are not paid on an insurance policy, the insurance is still useful in providing security for the ability to weather unforeseen and unfortunate events. Likewise, in the context of water rights, the Commission has noted that "[p]roperty rights can be 'enjoyed' even if they are not immediately exercised." They are "like money in the bank, enjoyable *and useful* even if not immediately spent."[23] Because the leased water rights were at least useful in enhancing SCWC's ability to meet future water supply contingencies, SCWC was not justified in relying upon the "not necessary or useful" clause in § 851.

Moreover, in failing to file a § 851 application, SCWC frustrated the important purposes served by § 851 review. The basic task of the Commission in reviewing § 851 applications is to determine whether the transaction serves

---

[23] *Re Camp Meeker Water System* (1989), 33 CPUC 2d 253, 296 (Conclusion of Law 24) (emphasis added).

the public interest.[24] The Commission is free to take such action, as a condition to the transfer of property rights, as the public interest may require.[25] In making this public interest determination, the Commission typically considers at least three factors. First, the Commission assesses whether the proposed transaction will impair the utility's ability to provide service to the public.[26] When a utility is proposing to lease what it considers to be excess capacity, this factor includes an analysis of whether the transaction truly involves excess capacity and whether the proposed lease will adversely affect service to customers.[27] Second, the Commission typically considers the ratemaking and accounting treatment of the proceeds of the proposed transaction. This factor often involves a determination of the proper allocation of the transaction proceeds between ratepayers and shareholders. [28] Third, consistent with its obligations under the California Environmental Quality Act (CEQA), the Commission considers the environmental impacts of the proposed transaction and whether any

---

[24] *E.g., Re Pacific Gas & Electric*, D.03-09-007, *mimeo* at 4.

[25] Decision No. 3320 (1916), 10 CRRC 56, 63.

[26] *E.g., Re Pacific Gas & Electric*, D.01-08-069, *mimeo* at 16.

[27] *Re Southern California Gas Co.* (1978) D. 89517, 1978 Cal. PUC LEXIS 1315, *32 - *33.

[28] *E.g., id.*, 1978 Cal. PUC LEXIS at *33 - *42; *Re Pacific Gas & Electric*, D.02-03-059, *mimeo* at 12-14.

conditions to mitigate environmental harm should be imposed.[29]

SCWC's failure to file a § 851 application has prevented the Commission from considering any of these important factors necessary to ensure that the lease of water rights was in the public interest. First, the Commission was deprived of an opportunity to assess whether the lease in perpetuity of the water rights could have an adverse impact on ratepayers by undermining SCWC's ability to respond to water supply contingencies. Had SCWC filed an application, the Commission could have considered imposing conditions on the proposed lease, such as requiring the lease to be for a definite term or requiring that SCWC have termination rights as necessary to protect the interests of ratepayers. Second, SCWC arrogated to itself the decision regarding accounting and ratemaking treatment of the lease proceeds. SCWC unilaterally chose to place the revenues in a below-the-line account solely for the benefit of shareholders. The failure to file a § 851 application prevented the Commission from passing judgment on SCWC's self-serving action. We find below that SCWC's choice was incorrect. By failing to file the required § 851 application in a timely fashion, SCWC has created the unfortunate issue of how to remedy eight years of improper ratemaking and accounting treatment of the lease proceeds. Third, SCWC prevented the Commission from

---

[29] *E.g., Re Sierra Pacific Power Co.*, D.03-04-043, 2003 Cal. PUC LEXIS 270 (denying § 851 application to sell water rights and hydroelectric facilities because of lack of required environmental impact information); *Re Southern California Gas Co.*, 1978 Cal. PUC LEXIS at *42 - * 43.

considering any environmental impacts associated with the transfer of water rights and whether any mitigations needed to be ordered. As the use or non-use of water rights to ecologically important water sources such as the American River can have significant environmental effects, it is not difficult to imagine that there were environmental impacts that needed Commission analysis.

Finally, Commission decisions show that SCWC should have filed a § 851 application. Prior to the 1994 lease, the Commission had issued decisions regarding similar dispositions of property showing that a § 851 application was required and served important purposes. In D.92-07-007, issued just two years before SCWC entered into the Folsom lease, the Commission rejected PG&E's argument that § 851 review was not necessary for PG&E's lease of assertedly unused property. PG&E claimed that its then unused fiber optic communications capacity was not necessary or useful within the meaning of § 851. The Commission disagreed, finding that PG&E was drawing "too fine a distinction" between portions of its assets that were used and portions that were unused.[30] The Commission found that § 851 requires that when an asset is devoted to service to customers, parts of that asset may not be disposed of without the Commission's approval.[31]

---

[30] *Re Pacific Gas and Electric Co.* (1992) 45 CPUC 2d 24, 29.

[31] *Id.* In 1996, shortly after the Folsom lease went into effect, the Commission similarly held that "leases for underutilized portions of useful utility property require Section 851 approval." (*Re Pacific Bell*, D.96-04-045, 1996 Cal. PUC LEXIS 265, *9).

SCWC's lease of a portion of its water rights is equivalent to PG&E's lease of a portion of its fiber optic capacity. Below, we find that the water rights were utility property acquired from Natomas Water Co. and had previously been used to serve customers. It was improper for SCWC to treat a portion of this water rights asset as useful while declaring a currently unused portion not useful. This was precisely the type of excessively fine distinction that the Commission held would not warrant an exemption from § 851

In D. 89517 (1978),[32] which also involved facts similar to the Folsom lease, the Commission engaged in a thorough § 851 review. There, Southern California Gas (SoCal Gas) proposed to remove a portion of its pipeline transmission facilities from utility service and lease it to a third party. SoCal Gas claimed that the facilities in question would soon become excess capacity and would no longer be needed to serve its gas customers. The Commission: (1) reviewed the proposed lease under § 851 and conducted a thorough analysis of forecasted gas transmission needs to determine whether current or future natural gas supplies would likely need to make use of the facilities; (2) addressed competing proposals for the accounting and ratemaking treatment of the lease proceeds; and (3) reviewed the environmental impacts of the proposed lease. As shown above, this exact same three-pronged analysis was warranted for SCWC's Folsom lease.

---

[32] 1978 Cal. PUC LEXIS 1315.

In recent decisions, this Commission has confirmed that utilities must file § 851 applications even when they believe the assets in question are no longer necessary or useful for utility service. In D.03-03-022, the Commission denied a requested exemption from § 851 for the sale of water rights and hydroelectric facilities claimed to be no longer used or useful, finding that the purpose of the § 851 process was for the Commission to make that determination.[33] The Commission reached a similar conclusion on a nearly identical set of facts in D.03-04-043.[34]

SCWC's reliance on D.82-12-121 is misplaced. There, the Commission declined to exercise § 851 jurisdiction over coal mine property PG&E had purchased in Utah in anticipation of construction of a plant that was later cancelled. With the cancellation of the plant and the absence of any cost-effective transportation of the coal resources, there was no evident utility purpose for the coal mine property, which had never been placed into utility service. In reasoning that § 851 approval for the sale of the assets was not necessary, the Commission found that, should PG&E need to replace the coal facilities at some future time, shareholders would bear the risk and cost of the replacement property.[35]

D.82-12-121 is inapposite for three reasons. First, PG&E's coal mine facilities were never devoted to utility

---

[33] *Re PacifiCorp*, 2003 Cal. PUC LEXIS 112, *1 - *3.

[34] *Re Sierra Pacific Power Co.*, 2003 Cal. PUC LEXIS 270.

[35] 10 CPUC 2d 647, 657.

service. Here, as we find below, the water rights asset was utility property and had been used to serve customers. Second, PG&E disposed of the entirety of its coal mine assets. PG&E's sale of the coal mine assets did not involve the excessively fine distinctions between portions of an asset that the Commission rejected in its 1992 PG&E decision. In contrast, SCWC leased only a portion of an asset that was useful in serving customers, exactly the type of fine distinction that the 1992 decision held does not excuse § 851 review. Third, unlike the PG&E shareholders, SCWC shareholders have not accepted the risk of any replacement water rights that the utility needs to acquire in order to make up for the portion of water rights that have been transferred to Folsom. Consequently, a key rationale for the 1982 PG&E decision simply does not apply here.

Similarly, D.88-04-068[36] does not support SCWC's position. There, the Commission determined that timber rights on watershed land were not necessary or useful for water utility service. However, timber rights are far removed from the actual water rights used to serve customers.[37] Here, SCWC has leased those water rights themselves, and those water rights are directly useful in the provision of water service.

Our analysis above has not relied on the circumstances that have occurred since SCWC entered into the lease in 1994. However, it bears noting that the ground water

---

[36] *Re Citizens Utilities Company*, 28 CPUC 2d 108.

[37] *See* D.96-04-045, 1996 Cal. PUC LEXIS 265.

contamination problems SCWC has since encountered and the increased need for surface water only underscore why § 851 review was necessary. By granting a lease in perpetuity of half of its surface water rights, now, less than ten years later, SCWC has placed its ratepayers at risk of paying significantly higher costs for its water supply. We note that the replacement contract with SMUD is only for five years and that it is on a "take or pay" basis, meaning that SCWC must pay for the full 10,000 AFY, whether or not SCWC needs that entire amount. The result is that, if water supply costs have not already exceeded the levels that would obtain in the absence of the Folsom lease, there is a real threat that this will occur in the not distant future. SCWC's failure to seek § 851 approval prevented the Commission from assessing the wisdom of what amounts to a transfer in perpetuity of water rights.

In conclusion, for the foregoing reasons, we conclude that SCWC violated § 851 when it failed to gain the Commission's approval prior to effectuating the Folsom lease. We must now consider the appropriate remedies for this violation.

The first remedy is dictated by § 851, which provides that any lease "made other than in accordance with the order of the commission authorizing it is void." As SCWC did not seek or obtain an order authorizing the lease, we must void the lease from its inception as to SCWC.

However, § 851 dictates a different result as to Folsom. The second paragraph of § 851 states that, as to any lessee "dealing with such property in good faith for value", there is a conclusive presumption that the property was not necessary or useful for the utility's performance of its duties. The

Commission has interpreted this language to "protect innocent purchasers from having their transactions invalidated solely on the ground that the utility's action in transferring the property was beyond its authority."[38] Accordingly, we conclude that Folsom's use of and payments for the leased water rights in the past are unaffected by the voiding of the lease as to SCWC.

Going forward, if SCWC wishes to have a valid lease with Folsom, it must seek our approval under § 851 forthwith. The prospective impact of the voiding of the lease on Folsom is less clear and has not been addressed by the parties. Accordingly, upon the issuance of this decision, we will invite briefing by the parties regarding the rights of Folsom in each of the following potential circumstances: (1) SCWC seeks and obtains § 851 approval for a prospective lease to Folsom; (2) SCWC chooses not to pursue a prospective lease to Folsom and hence does not file a § 851 application; or (3) SCWC seeks § 851 approval of a prospective lease, but the request is denied. The rights of, and impacts upon, Folsom are important because these issues will affect whether an available option is for SCWC to regain the use of the water rights it attempted to lease to Folsom.

Within 30 days of the issuance of this decision, we will require SCWC to either file an application for prospective approval of a lease with Folsom or to indicate that it does not

---

[38] *Re Pacific Gas and Electric Co.*, 45 CPUC 2d at 30. This decision also makes clear that the protection for innocent purchasers cannot be interpreted to vitiate the primary requirement that the utility gain advance approval of transfers of assets. *Id.*

wish to have a valid lease with Folsom and does not intend to make water rights available any longer. Whichever course SCWC elects, it must brief all three of the issues set forth in the previous paragraph.

In a subsequent section, we will consider ORA's recommendation to fine SCWC for its violation of § 851.

B. Ratemaking Treatment for Lease Revenues

We now turn to the ratemaking issue. SCWC argues that the water rights were never in rate base, are non-utility/non-regulated property of SCWC and therefore the lease proceeds should accrue only to shareholders.

We do not accept that proposition. When SCWC purchased the Natomas Water Company in 1964, the transfer of water rights was included in the transaction. As even SCWC admits, certain amounts of those rights were exercised previously by the Natomas Water Company and subsequently by SCWC. The entire cost of the Natomas Water Company purchase, which included 32,000 AFY was borne by the ratepayers. Shareholders were not separately responsible for recovery of any of the costs. We see no reason to assign the full benefit of the water rights to shareholders merely due to the fact that as SCWC states, "At that time – 1963 – it was common practice to attach no monetary value to water rights and therefore SCWC acquired these water rights for free."[39] The fact that the parties may not have assigned a particular line item value to the water rights does not mean those rights were free, especially since

---

[39] SCWC Opening Brief, p. 19.

Natomas had obtained a benefit from the exercise of some of those water rights. Notwithstanding the lack of a separate itemization of the value of the acquired water rights, it is clear that the value of those property rights was included in the overall purchase price paid by SCWC. We determine that the entire amount of water rights was utility property at the time of the purchase. After the 1967 sale to Folsom, the entire remaining 10,000 AFY, which includes the 5,000 AFY being leased to Folsom, continued to be utility property.

Based on the fact that ratepayers, not shareholders, have borne the cost of obtaining the water rights at issue as part of the purchase price of Natomas, it is reasonable to allocate most of the benefits of the lease to the ratepayers from the inception of the lease. Further supporting the assignment of most of the lease revenues to ratepayers is the fact that the revenues are not the product of capital investment in plant or facilities by SCWC. This was an investment in preexisting water rights, funded by ratepayers. On the other hand, it is appropriate to assign shareholders a minority of the lease revenues in order to provide some reward for the leasing of an asset that probably would have been underutilized for most of the period from 1994 to the present had it not been leased. Based on these considerations and the unique facts of this case, we determine that 70% of the lease revenues should be assigned to ratepayers and 30% to shareholders. This apportionment should apply to any lease revenues accrued from the inception of the lease through the date of this decision.

SCWC's failure to seek § 851 review for the lease creates an unfortunate issue of how to enable ratepayers to gain the benefit of their appropriate 70% share of the revenues that SCWC previously has unilaterally assigned for the benefit of

shareholders. We agree with ORA that the best approach is to require SCWC to credit customer bills by the appropriate ratepayer share, plus interest. Although a strong argument could be made that the interest rate should be fixed at SCWC's authorized rate of return for the Arden-Cordova district – that representing the return that SCWC's shareholders can be expected to have achieved on the lease revenues – we will adopt ORA's lower proposed interest rate of 7%. Accordingly, SCWC is required to refund to ratepayers 70% of lease revenues accrued from the inception of the lease through the effective date of this decision, plus 7% interest.

We will direct SCWC to file an advice letter within 20 days that calculates the 70% share of lease revenues, plus 7% interest, that should be credited to ratepayers and proposes a method for ensuring that this full amount is equitably credited on ratepayer bills. SCWC's advice letter will be subject to protest in accordance with General Order 96-A.

In the event that there is a valid lease in the future, SCWC will collect additional lease revenues. We will leave for a later decision the determination of the apportionment of any lease revenues that SCWC may collect in the future. If SCWC files a §851 application, our determination will be made in that docket. Otherwise, the determination will be made in this docket.

B. Fine for Violation of § 851

The remaining issue is whether and, if so, how much SCWC should be fined for its failure to gain § 851 approval for the Folsom lease prior to allowing the lease to go into effect. ORA seeks a total fine of $180,000, representing a $20,000 fine for the violation of § 851 and an additional

$20,000 fine for each year that SCWC improperly recorded the lease revenues in a below-the-line account that benefited only shareholders.

We begin our analysis by noting that the Public Utilities Code and Commission precedent would permit a potential fine significantly higher than the fine that ORA has requested. Section 2107 authorizes the Commission to levy a fine of between $500 and $20,000 for each offense. Section 2108 provides, in relevant part, that "in case of a continuing violation each day's continuance thereof shall be a separate and distinct offense." Consistent with these two provisions, we have previously held that the fine for a utility's violation of § 854 – a statute similar in content, structure and purpose to § 851 – should be based on a per offense fine amount multiplied by the number of days between the effectuation of the transfer for which Commission approval was required and the date the application was finally filed.[40] Here, even if we just count the time between the effectuation of the lease and the initial airing of this issue in SCWC's 2001 general rate case, the period of violation amounts to six years or 2,190 days. In light of the range of penalties authorized by Section 2107, the potential range for a penalty amount could extend between $1,095,000 and $43,800,000.

In determining the size of the penalty, where one is levied, the Commission has held that the size of the fine should be proportionate to the severity of the offense and has

---

[40] *Re Wild Goose Storage, Inc.*, D.03-06-069, 2002 Cal. PUC LEXIS 975, *28 - *29.

applied the criteria adopted in D.98-12-075, which issued in the *Affiliate Enforcement Rulemaking*. These criteria include: (1) the severity of the offense; (2) the conduct of the utility (before, during and after the offense); (3) the financial resources of the utility; (4) the totality of the circumstances related to the violation; and (5) the role of precedent.

Severity of the offense includes a consideration of the physical or economic harm caused to the victims or to the integrity of the regulatory process, unlawful benefits gained by the utility, and the number of violations. The conduct of the utility includes the utility's actions to prevent the violation, detect the violation, and disclose and rectify the violation. With respect to the financial resources of the utility, the Commission considers both the need for deterrence and constitutional limitations on excessive fines. Consideration of the totality of the circumstances requires the Commission to look at the unique facts of each case, which may mitigate or exacerbate the degree of wrongdoing, in the furtherance of the public interest.

When we apply these criteria to the facts presented by this Application, we reach the following assessment. As we explain above, we do not find convincing SCWC's argument that the lease of water rights did not involve property that was necessary or useful to utility service. We have noted Commission decisions prior to the 1994 lease agreement that show that § 851 review was required that are far more apposite than the decisions on which SCWC relies. At best, SCWC took a considerable risk when it determined that it did not need Commission authority for the lease. SCWC should have known that Commission approval would be necessary, particularly in light of the fact that the lease essentially involves a permanent transfer of useful water

rights, that the lease proceeds would need to be allocated between ratepayers and shareholders, and that the environmental impacts of the lease needed to be considered. The offense, failure to comply with § 851, is serious—so serious that the statute itself provides that a transaction pursued without prior Commission authorization is void and of no effect. SCWC's violation has caused actual harm to customers in that they have been deprived of the benefits of the lease revenues in setting rates and threatens to cause additional harm in that the lease may soon, if it has not already, drive up water supply costs that may be borne by ratepayers. On the flip side, SCWC shareholders have improperly benefited from the utility's unilateral decision to have the lease revenues benefit only shareholders. In sum, SCWC's violation is a highly severe offense, one that harmed ratepayers and undermined the regulatory process mandated by the legislature. Accordingly, the severity of the offense factors argues strongly in favor of an elevated fine amount.

SCWC's conduct has been characterized by a repeated denial that it was required to file a § 851 application both when ORA raised this issue in the 2001 rate case and in this proceeding. In light of the authorities reviewed above that show that § 851 approval was required, this view was unjustified. SCWC's denial of any wrongdoing militates in favor of a higher fine amount.

As a large class A water company, SCWC has substantial financial resources and steady profits. This factor also argues for an enhanced penalty amount.

With respect to precedent, the most germane recent decision is the *Wild Goose* decision,[41] in which the utility failed to obtain the required Commission approval under Section 854. The Commission settled on a fine of $51,000 based on the statutory minimum fine per offense of $500 and a violation period of 103 days. However, there are important differences that justify a significantly higher fine in this case. Here, the violation period is almost 20 times longer than in *Wild Goose*. In addition, there were mitigating factors in *Wild Goose*, such as the lack of harm to ratepayers, that are not present here.

In light of the foregoing analysis, we would be justified in imposing a fine of at least the $1,095,000 statutory minimum. However, ORA has limited its fine request to $180,000. Balancing these two considerations, we will levy a fine of $1,095,000, but will suspend $915,000 of that amount and require SCWC to pay at this time a fine of only $180,000. We place SCWC on notice that, should it fail to comply with any of the requirements of this decision, it will be subject to imposition of the entire fine amount. In addition, we give notice that SCWC is subject to additional fines for each day it continues to allow Folsom to lease water rights without having requested § 851 approval. The fine period would begin after the 30-day period we describe above for SCWC to either seek § 851 approval or to indicate that it is somehow terminating the lease. In other words, putting aside the suspended fine amount, there would be no additional fine if within 30 days, SCWC seeks § 851

---

[41] 2002 Cal. PUC LEXIS 975, *22 - *30

approval or indicates that it is terminating the lease. SCWC would be subject to an additional fine amount, however, if SCWC does not seek § 851 approval but continues to allow Folsom to use the water rights.

The penalty shall be paid to the General Fund as detailed in the ordering paragraphs.

COST OF SERVICE ISSUES

14. Cost of Capital

SCWC requests a rate of return on rate base of 10.15% for each of the years 2003, 2004 and 2005. ORA recommends the Commission adopt a rate of return on rate base of 8.54% for 2003, 8.52% for 2004 and 8.55% for 2005. In determining the proposed rates of return, both parties recommend adoption of a capital structure composed of 50% long-term debt and 50% equity. SCWC recommends a cost of debt of 7.8% and a return on equity of 12.45% for 2003, 2004 and 2005. ORA recommends a cost of debt of 7.67% for 2003, 7.63% for 2004 and 7.68% for 2005 and a return on equity of 9.41% for each of the years.

As discussed below, we adopt an average cost of debt of 7.67% in 2003, 7.63% in 2004 and 7.68% in 2005 and a return on equity of 9.90% for each of the years. This equates to a rate of return on rate base of 8.79% for test year 2003, 8.77% for 2004 and 8.79% for attrition year 2005.

14.1 Cost of Debt

SCWC derived its cost of debt by calculating the embedded cost of debt currently outstanding and the projected cost of new debt issues. SCWC derived a coupon rate of 8.00% for new debt issues by adding a spread of 150 basis points to the Blue Chip Financial Forecast of long-term

treasury yields. The 150 basis point spread is an amount consistent with current spreads for an "A+" rated utility issue. To the 8.00% coupon rate for new debt issues, SCWC added 13 basis points to approximate the annual cost factor for issuing new debt, to arrive at a cost of new debt equal to 8.13%.

Once both the embedded cost of debt and the cost of new debt were calculated, SCWC adjusted the embedded cost of debt yearly to reflect reductions in debt due to sinking fund payments, maturities, and projected new debt issues. Accordingly, SCWC derived an estimated, effective cost of long-term debt for 2003 through 2005 of 7.77%, 7.83%, and 7.84%, respectively.

ORA updated the forecast used to determine the coupon rates, using the most recent DRI forecast. Table 5-1 in ORA's testimony shows its resulting forecast of the new issue coupon rate to be 6.63% for 2003 and 8.47% for 2005. The associated effective interest rates are shown to be 6.76% for the 2003 new issue and 8.62% for the 2005 new issue. ORA's resulting forecast of the average cost of debt is 7.67% in 2003, 7.63 in 2004 and 7.68 in 2005.

We reject SCWC's contention that ORA did not account for the issuance costs of new debt. As described above, ORA increased its forecast of the 2003 new issue coupon rate of 6.63% to an effective rate of 6.76% (13 basis points) and increased its forecast of the 2005 new issue coupon rate of 8.47% to an effective rate of 8.62% (15 basis points). This methodology is similar to SCWC's where it took the forecasted coupon rate of 8.00% for 2003 and 2005 and increased it by 13 basis points to derive the effective rate of 8.13%, for both years. Since ORA's forecast incorporates

more recent information, to which SCWC does not object, we will adopt ORA's forecast of average long-term debt costs for the period 2003-2005.

14.2 Return on Equity

SCWC requests a return on equity of 12.45 percent. The utility performed four common equity market cost analyses, followed by three book value return on equity analyses. SCWC derived a market cost estimate of 10.87% by averaging costs indicated by the Ibbotson CAPM Method (11.98%), the Fama-French Three Factor Model (10.80%), the Risk Premium (RP) Analysis (10.89%) and Discounted Cash Flow (DCF) Model (9.81%).

After deriving the market-required return rates on market price of SCWC's equity, SCWC then converted those rates to "book value" equivalent return rates. SCWC asserts that a return based strictly on market prices is applicable directly to book value only if the price to book value ratio is already 1.00. Since its current market to book ratio is about 1.9, SCWC used three methods to make the book value conversion. SCWC's conversion of the DCF market cost results in a book value return on equity of 11.10%. The use of the Modigliani & Miller Conversion of Market Leveraged Cost results in a return of 11.58% and the Brigham Leverage Curve-Based Conversion results in a return of 11.66%. The average of the three methods is 11.45%.

To its estimated book value return on equity of 11.45%, SCWC added 10 basis points to account for incremental business risk resulting from return variability, market capitalization, customer mix, capitalization size shortfall and other specific risks. SCWC asserts that water utilities, being the most capital intensive of the utilities as well as the

smallest, are particularly susceptible to the risk phenomena of combined forms of leverage and small size. In addition, SCWC added 90 basis points to its required book value return on equity to account for the risks created by the Commission's issuance of Resolution W-4294 and D.03-06-072 in the balancing account OIR.

ORA's 9.41% return on equity is derived from a quantitative analysis using two financial models, DCF and RP, to estimate investors' expected return on equity for SCWC. ORA applied both models to a group of comparable water utilities. The DCF model projected returns on equity of 8.00% based on the 3-month dividend yield, 8.00% based on the 6-month dividend yield, and 7.99% based on the 12-month dividend yield, with an average of 8.00%. The RP model combined average equity risk premiums with average interest forecasts for the test period (years 2003 to 2005). Based on the average 10-year risk premiums, ORA calculated an expected return on equity of 10.59% for the 10-year Treasury bond yield and 10.90% for the 30-year Treasury bond yield. Using the 5-year average risk premium produced expected returns of 10.70% for the 10-year Treasury bond yield and 11.12% for the 30-year Treasury bond yield. Averaged together, ORA calculated an average ROE of 10.83% based on the RP model. Averaging the results of the two financial models produces ORA's expected return on equity of 9.41%.

As discussed below, we have developed a return on equity range and determined that the 9.9% midpoint value of that range will provide SCWC an appropriate return on equity for the years 2003 through 2005.

14.3 Return on Equity – Discussion of Models

The differences in return on equity recommendations between SCWC and ORA are caused by (1) SCWC's adjustment to the model results to convert from a market basis to a book value basis, (2) SCWC's use of two additional financial models, (3) differences in the financial model assumptions and inputs, and (4) SCWC's adjustments to reflect additional risk. This section discusses the first three items

Regarding SCWC's position that it is inappropriate to compare book value returns with market derived returns, it is not clear that the adjustment or the magnitude of the adjustment proposed by SCWC is reasonable or necessary. SCWC's use of the market to book conversion raises its equity return recommendation from 10.87% to 11.45%, or 58 basis points. ORA argues plausibly that the current high market to book ratios for regulated water companies indicate that authorized returns should actually be lowered rather than raised. More importantly, we must recognize that comparisons and averaging of DCF and RP results have been the basis for many of our decisions regarding equity return levels. These past Commission authorized returns have not included SCWC's proposed adjustment. SCWC has not demonstrated, based on its financing experience, or any other practical criteria why the adjustment is necessary at this time. We are reluctant to make a make a major change such as this without convincing evidence supporting the necessity for the change. We will therefore not include the market to book conversion in determining a reasonable equity return. This treatment and the return on equity that we are authorizing

today are in line with recent authorizations for other Class A water companies.

SCWC argues that an additional premium is necessary in factoring risk, because small companies are at greater risk than large companies. Specifically, in its CAPM analysis, SCWC uses a small company premium, which is calculated using data from the 2001 Ibbotson Associates SBBI yearbook. The data include all stocks listed on the New York Stock Exchange, American Stock Exchange, and the NASDAQ. The vast majority of the companies on these exchanges are non-regulated and non-water. The Commission has stated that water utilities should not be compared to companies in other industries (D.01-04-034, *mimeo.* at p.13-14; D.90-02-042, *mimeo.* at p. 38.) As stated in D.92-01-025, "[d]ue to the revenue recovery mechanisms in place for water utilities, we find that water utilities do not face the same overall risks as energy and telecommunications utilities." Therefore, for the determination of a reasonable range for equity returns we will not rely on the CAPM, nor will we use the Fama-French Three Factor Model, which appears to be similar in many respects to the CAPM.

The financial models we will consider are the DCF and RP models, both of which have been used in the past by the Commission in determining equity returns for Class A water utilities. Also, both models were run by ORA and SCWC, although there were significant differences in the results.

In its prepared testimony analysis, ORA did not include Artesian Resources as one of the comparable companies. In response to SCWC's criticism for the omission, ORA reran the DCF and RP models the same way they were run for its report, with the inclusion of Artesian Resources. Based on

numbers provided during evidentiary hearing,[42] if Artesian Resources were included in the comparable group, ORA's DCF analysis would yield a return of 8.35% and the RP analysis would yield a return of 10.52%. The average of the methods would be 9.43%, two basis points higher than ORA's recommended value of 9.41%.

In many of our decisions we have defined a reasonable range for equity returns. The authorized return would fall somewhere within that range. Model results for both ORA and SCWC show a wide range of equity returns. ORA's original analysis resulted in an 8.00% result from its DCF model, and a 10.83% result from its RP model – 283 basis points apart, or a recommended average that is 17.6% higher than the DCF result, and 13.1% lower than the RP result. SCWC asserts that this large disparity of 283 basis points between the DCF and RP results makes the ORA analysis unreliable. With the inclusion of Artesian Resources in the comparable group, ORA's spread between the DCF and RP model results would be reduced to 217 basis points. In its market cost of equity analysis, SCWC shows a range from 9.81% to 11.98%, or 217 basis points. The spread between SCWC's DCF (9.81%) and RP (10.89%) results, which amounts to 108 basis points, is somewhat less than the comparable ORA spread. However, it is clear that a fairly large spread in model results is common and not counter to our objective to determine a reasonable range. Once such a range is determined, we will exercise our judgment in determining the authorized return for SCWC.

---

[42] ORA/Wilson, RT 571, 573.

Regarding the differences in the results, SCWC and ORA criticize each other's models. For instance, for the DCF, ORA criticizes SCWC's adjustment of the dividend yields to account for market pressure and issuance costs. ORA states that, in D.92-11-047, the Commission rejected the use of issuance costs and sinking fund effects in determination of rate of return. SCWC criticizes ORA's DCF formula on the grounds that ORA uses data from the most recent six and twelve- month periods, and not just the most recent three-month period, which SCWC characterizes as the only "current" data. ORA asserts that its approach takes advantage of a longer time period to average out any short-term aberrations, though in this case the results for the three, six and twelve months were all within one one-hundredth of a percent.

Regarding the RP analysis, SCWC criticizes ORA's model on the ground that it uses "too much history," which is wrong because "history does not repeat itself." ORA argues that using just the 5-year period, which SCWC proposes, would ignore the longer-term trends in the model. ORA asserts that its RP model is superior to SCWC's proposal because it balances historical trends in the risk premium with forecast interest rates to arrive at return on equity.

Based on the record, we do not see either SCWC's or ORA's analyses as clearly superior, and we will consider the determinations of both ORA and SCWC. We adopt an equity return range of 9.08% to 10.70% for SCWC. We derive the floor rate by taking the simple average of the

parties' DCF results and the ceiling by taking the simple average of the RP results.[43]

In order to determine where SCWC should fall in that ROE range, we next assess the risk factors.

14.4 Return on Equity – Discussion of Risk

We see no indication of high financial, business or regulatory risk for SCWC. After considering that along with evidence on the financial models, adjustments to the models, interest rate trends, the current economy and our informed judgment, we have determined that the midpoint of our range (9.90%) reflects an appropriate equity return for SCWC. We therefore authorize this return for SCWC's Region III for the years 2003, 2004, and 2005. This return along with our adopted capital structure and costs of debt, equates to a rate of return on rate base of 8.79% for test year 2003, 8.77% for test year 2004 and 8.79% for attrition year 2005.

Risk factors consist of financial, business and regulatory risk. Financial risk is tied to the utility's capital structure. The proportion of its debt to permanent capital determines the level of financial risk that a utility faces. As a utility's debt ratio increases, a higher return on equity may be needed to compensate for that increased risk. Both SCWC and ORA utilize a capital structure consisting of 50% debt and 50%

---

[43] For the DCF, SCWC shows a return of 9.81% while ORA shows 8.35% (including Artesian). The average is 9.08%. For the RP, SCWC shows a return of 10.89% while ORA shows 10.52% (including Artesian). The average is 10.70%.

equity, and neither party asserts increased or decreased financial risks associated with that structure.

Business risks pertain to uncertainties resulting from competition and the economy. A utility that has the most variability in operating results has the most business risk. Regulatory risk pertains to new risks that investors face from future regulatory actions that we, and other regulatory agencies, might take. Assessments of these risks are conducted to determine whether there is a need to increase return to compensate investors for added risk.

In its application, SCWC identifies and quantifies two elements of risk. First, it asserts business risk associated with the capital intensive nature of water utilities and operating leverage concerns caused by California water utilities having higher than average quantities of purchased water (fixed costs). However, the Commission has provided various regulatory mechanisms that deal with this risk – balancing accounts for purchased water, purchased power and pump taxes; memorandum accounts for catastrophic events; memorandum accounts for SDWA compliance; 50% fixed cost recovery and construction work in progress in rate base. Also, in this decision, we have approved memorandum account treatment for the Calipatria treatment plant. All of these factors tend to reduce risk associated with the capital intensive and high fixed cost nature of SCWC's operations. We see no reason to add a premium to the ROE to compensate for these risks.

The second risk specifically identified by SCWC concerns potential adjustments to balancing account procedures raised in Resolution No. W-4294. At the time of the application filing, related issues were being considered in

R.01-12-009 where, on June 19, 2003, the Commission issued a final decision. In summary, D.03-06-072 revised the existing procedures for recovery of under collections and over collections in balancing-type memorandum accounts (accounts) existing on or after November 29, 2001 as follows: (1) If a utility is within its rate case cycle and is not over earning, the utility shall recover its account subject to reasonableness review; and (2) If a utility is either within or outside of its rate case cycle and is over earning, the utility's recovery of expenses from the accounts will be reduced by the amount of the over earning, again subject to reasonableness review. The utility shall remove the amount of the over earning from the account and shall amortize it below the line. Utilities shall use the recorded rate of return means test to evaluate earnings for all years.

Conclusion of Law 7, states in relevant part:

> "[T]he readjustment of a utility's specific rate of return is not within the scope of this industry-wide proceeding. The appropriate forum for such a utility-specific inquiry is a utility's general rate case or other appropriate proceeding the Commission may designate in the future."

The affect of D.03-06-072 is to limit recovery of costs subject to balancing accounts when the utility is over earning its authorized rate of return. The issue is whether this imposes additional risk on the utility to the extent that a premium should be added to the equity return. In the policy discussion of D.03-06-072, we state:

> "Like the Edison case, we believe that a revision to our existing procedures is

necessary here in order to effectively correct distorted results. The existing procedures for recovery of under and over collections in balancing accounts, which we suspended as of November 29, 2001, were originally established for the utilities to recover unanticipated increases in electricity costs between general rate cases, without the need to file an additional rate case application. The procedures also served the purpose of protecting shareholders from having to finance large unanticipated expenses until the next general rate case.

"These procedures served, in effect, as insurance to protect a utility against its failure to earn its authorized earnings due to unanticipated expenses beyond the utility's control. When a person obtains insurance, the insurance is paid or invoked when the event insured against occurs. Similarly, offset balancing account recovery should only occur when the utility fails to earn up to its authorized rate of return due to unanticipated expenses beyond its control and that are the subject of the balancing account. To the extent a utility is earning above its authorized rate of return, recovery of the balancing account should be reduced by the amount of over earning since the event insured against (i.e., the failure to earn its authorized earnings) has not occurred.

> "Thus, the existing procedures become problematic when they have the effect of enhancing utilities' earnings above the Commission-authorized rates of return. It is unreasonable and unnecessary to permit the utilities to pass through to ratepayers the dollar-for-dollar costs accumulated in their balancing accounts when these same utilities are earning more than their authorized rate of return, particularly when their ratepayers are also experiencing the same increased electrical costs in their own homes. To permit such recovery would be to grant the utilities an unanticipated windfall at ratepayer expense." (D.03-062-072, *mimeo.* at pp. 15-16.)

As described above, D.03-06-072 corrects an imbalance in the risks associated with previous balancing account procedures. The opportunity for unanticipated windfalls caused by balancing account protection should not have existed from the beginning. It would be illogical for us to increase the ROE by 90 basis points, as requested by SCWC, to compensate for the loss of what has been determined to be an illegitimate opportunity.

Additional information in the record indicates that SCWC is financially healthy. In evaluating SCWC's risk, ORA considered the Standard & Poor's (S&P) credit rating of SCWC, since this rating factors in a company's total risk. S&P rates SCWC A+/Stable, Business Profile 3. ORA Table 3-1, contained in Exhibit 9, shows S&P benchmark financial ratios as compared to SCWC for the years 1997-2001. According to ORA, based on those ratios, SCWC's overall

rating would be "A," a strong indication that it is a financially healthy company. Placing SCWC in the middle of our ROE range appears fair and puts the authorized return in line with that recently authorized for other large water utilities under our jurisdiction.[44]

15. Sales

SCWC and ORA do not agree on forecasts of the annual sales per commercial customer, as summarized in Paragraph 3.02 of the Stipulation. In estimating sales for the commercial class, SCWC used a monthly regression model, while ORA used the Modified Bean method, which incorporates annual data. As discussed below, we will adopt SCWC's estimates for commercial sales per customer.

15.1 Discussion

The monthly regression model used by SCWC produces results which are statistically more significant than that produced by ORA's model, which failed the F-statistic and Durbin – Watson tests. Additionally, the Water Division[45]

---

[44] For example, in D.03-05-078, Suburban Water Systems was authorized a 9.84% ROE for 2003 – 2005; in D.03-02-030 California-American Water Company was authorized a 10.25% ROE for 2003 – 2005; and in D.03-09-021 California Water Service Company, based on a joint recommendation, was authorized a 9.70% ROE for 2002-2005.

[45] See Exhibit 54, which quotes the Commission's Water Division document, "Water Regulatory Policy," prepared in August 1997, where it is noted that sales forecasting is an important part of GRC proceedings and that, "[i]n 1992, the Modified Bean method was replaced with an

Footnote continued on next page

and Commission decisions[46] have encouraged the use of a monthly regression model. ORA does not address these points, which are significant in considering a return to the use of the Modified Bean Method. For these reasons, we adopt test year sales per customer for the commercial class, as forecasted by SCWC.

ORA's criticisms of the monthly regression model lack specific evidence and analysis. For instance, in criticizing SCWC's conservation factor, ORA states that the conservation factor used in the utility's model is an unreliable variable in that it is not measuring a phenomenon known to affect consumption. ORA does not provide evidence that shows the factor is unreliable, does not quantify the effect of using the factor, does not analyze the effects of modifying the value of the factor, does not indicate how ORA specifically addressed conservation, and does not provide an alternative method for addressing the effects of conservation. Such information would be helpful in evaluating the merits of ORA's position.

Econometric Model which expanded the statistical data information and calculations to include additional variables."

[46] See D.94-06-033, 55d CPUC 2d at 190, where the Commission noted that the Division of Ratepayer Advocates had introduced an econometric forecasting method in two water company rate cases and was "encouraging all Class A water companies to use this method instead of the more traditional modified Bean forecasts." Also, the Commission stated that "[b]ecause it produces more accurate estimates of future sales than the Bean method, the econometric model can reduce utilities' risk of underestimating (or overestimating) sales revenue."

16. Water Supply Mix

For the Claremont CSA, SCWC projects that approximately 38% (2,130,623 Ccf) of its water supply for the test years would come from groundwater pumped from SCWC wells within the CSA. ORA, on the other hand, estimates an amount of 2,684,500 Ccf, or 48% for both years

SCWC argues that ORA's estimate is unrealistic for the following reasons. First, groundwater production has declined for the past 5 years and is expected to continue to decline. Second, the Master Water Level Index in the Six Basins, from which the Claremont wells draw, is falling, thereby reducing the amount of water that SCWC is capable of pumping from its wells. Third, SCWC's wells in the Claremont CSA also suffer from contamination concerns. Wells have been unreliable due to water quality issues (VOCs, bacteriological, and mechanical). In addition, in 2004, the new standard for arsenic becomes effective and the largest single producing well in the Claremont CSA will have to be shut down due to arsenic. Fourth, the two wells that are budgeted for the Claremont CSA (1 for 2003 and 1 for 2004) are intended to be replacement wells, not to provide an increase in production capacity. These new wells are needed because 16 out of 18 SCWC-owned wells in the Claremont CSA are more than 50 years old, with an average age for the 18 wells of 69 years.

ORA argues that its recommendations for Claremont are based on better, more realistic analysis than SCWC's and are consistent with its approach in other districts. ORA asserts that its forecast discards unusually high and low years to try to predict a more "average" year in the future based on past trends and considers the fact that two new, deep wells -

which are more immune to spikes in rainfall - are scheduled to be built by the company in 2003 and 2004

As discussed below, we adopt a groundwater pumped amount of 2,328,374 Ccf for both 2003 and 2004.

16.1 Discussion

The groundwater production in the Claremont CSA has declined substantially and is unlikely to return any time soon to levels achieved in the 1997 to 1999 timeframe. SCWC has provided information showing that new wells in 2003 and 2004 will replace and not supplement groundwater production. The recorded information for the years 2000–2002 indicates significantly less pumped water than for the years 1997-1999,[47] and is significantly less than ORA's forecasted amounts. However, the data are not consistent with SCWC's assertion that the decline in groundwater production over the past five years will continue. Recorded year 2002 groundwater production of 2,328,374 Ccf is higher than the 2001 amount of 2,130,617 Ccf and very close to the 2000 amount of 2,389,100 Ccf. The SCWC witness indicated that 2002 recorded data were not available at the time estimates were prepared and that the expectation was that production would be similar to that recorded in 2001.[48] We see no reason why the most recent recorded amount of 2,328,374 Ccf for 2002 cannot be obtained from

---

[47] See Exhibit 61. The recorded amounts for 1997 through 2002 were 3,619,000 for 1997; 3,088,000 for 1998; 2,932,500 for 1999; 2,389,100 for 2000; 2,130,617 for 2001 and 2,328,374 for 2002.

[48] SCWC, Wahab, Tr. 890.

groundwater wells in 2003 and 2004. We adopt 2,328,374 Ccf as the quantity of water from wells for both 2003 and 2004 and assume that purchases will constitute the remaining portion of water supply for each of those years.

17. Supply Cost Increases

SCWC forecasted its supply costs – cost of purchased power, cost of purchased water, and pump taxes – for the test years 2003 and 2004. SCWC used the most current rates for each of the purveyors to forecast its supply costs for 2003. SCWC and ORA have agreed that all purveyor rates utilized in calculating purchased water and purchased power costs should reflect current purveyor rates when the final decision appendices are compiled.

For the second test year, SCWC inflated the purchased water and purchased power costs to cover the anticipated increase in purveyors' rates. SCWC states that inflating first test year costs to derive second test year costs is commonly done for many expense items in the general rate case. ORA, on the other hand, held the supply costs at the 2003 levels when projecting 2004 costs. We will follow ORA, as discussed below.

17.1 Discussion

We will not adopt SCWC's proposal for two reasons. First, the record does not include a detailed basis for the proposal. The company's testimony indicates only that the rates are inflated to cover anticipated increases. Without a detailed description, we cannot determine whether SCWC's estimating methodology is reasonable and balanced in considering possible decreases as well as increases. For instance, it is not clear whether, in estimating purchased

power rates, the company considered the recent decrease in Southern California Edison's electric rates (D.03-07-029). The effect of that decrease can be incorporated in the decision for this GRC for 2003, as agreed to by both ORA and SCWC, but how the rate for 2004 should be adjusted is unclear.

Second, the issue of balancing account recovery for water utilities was the subject of R.01-12-009. In D.03-06-072, the Commission determined that increases related to balancing account recovery should be granted only to the extent that the utility's rate of return does not exceed authorized levels. Forecasting future water supply rate increases in this GRC would subvert the review process set forth in D.03-06-072. That process uses an earnings test to determine whether or not any such increase, or any portion of the increase, should be reflected in rates. SCWC can use the processes adopted in D.03-06-072 to mitigate the effects of 2004 increases, if any.

18. General Office Labor

GO labor includes labor associated with common customer account expenses and A&G expenses. SCWC estimates GO labor to be $7,765,300 in 2003 and $8,120,400 in 2004, while ORA estimates $6,445,900 for 2003 and $6,627,700 for 2004.

As discussed below, we adopt GO labor in the amounts of $6,864,200 for 2003 and $7,077,000 for 2004.

18.1 Discussion

A reasonable estimate of GO labor lies somewhere between the SCWC and ORA numbers. ORA used 2001 recorded expenses and escalated that amount by labor

inflation factors to estimate the test year amounts. As SCWC points out, that methodology does not consider the effects of the CPP. On the other hand, even when considering the effects of the CPP, SCWC's estimates appear to be high when compared to recorded information.

The last recorded year not affected by the CPP was 2000. GO labor expense for that year was $5,723,700.[49] SCWC's test year 2003 request of $7,765,300 exceeds the 2000 recorded expense by $2,041,600, or 35.7%, which is a substantial three-year increase. SCWC's testimony offers little in the way of justification for the large increase other than identifying the need for an additional auditor and indicating that some of the unfilled vacancies were necessary to fulfill the requirements of the Sarbanes-Oxley Act of 2002 and other new Securities and Exchange Commission rules. When possible, recorded data is useful in testing the reasonableness of utility budgets. We note that the recorded 2002 GO labor expense amounted to $6,002,175,[50] which is 20% less than the $7,519,900 estimated by SCWC for that year. The difference appears to be greater than the effect of the CPP. SCWC explains, "Although the CPP ended in mid-2002 and the hiring freeze was removed, many positions were not actually filled until the end of 2002, or the beginning of 2003, so again the 2002 recorded expense does not include some or all of the costs associated with these

---

[49] See Exhibit 27, Table 4-A.

[50] See ORA Opening Brief, p. 19.

positions."[51] SCWC further states that, at the time of the application (November 2002), there were 14 positions in the general office that were not filled. The expense portion of the related salaries amounted to $740,700. This is consistent with SCWC's explanation that during the CPP there was a company-wide hiring freeze and, at its peak, there was close to a 10% vacancy rate within the entire company (including proposed new positions). If the recorded 2002 expense were adjusted for the 14 vacancies, the amount would be $6,742,875. We feel this would be a reasonable basis for determining the test year estimates for GO labor expense. The positions have either been filled or are necessary for auditing purposes. SCWC used labor inflation factors of 1.8% for 2003 and 3.1% for 2004. Application of those factors to the adjusted 2002 recorded expense results in our adopted estimates of $6,864,200 for 2003 and $7,077,000 for 2004.

SCWC included 1.5% per year increases for equity adjustments. The utility's showing, however, does not provide the basis for the adjustment or describe how the percentage was determined. Therefore, we will not adopt the adjustment. SCWC also includes an explicit overtime factor based on year 2000 information, indicating that overtime during the CPP timeframe is not indicative of normal operations. In this case, it is not clear that 2000 overtime is reflective of what can be expected in the test years. SCWC had estimated 2003 GO labor expense that was 35.7% higher than the 2000 recorded amount. Our adopted amount for

---

[51] Darney-Lane, Exhibit 45, pp. 1-2.

2003 is 19.9% higher than the 2000 recorded amount. Some of the overtime incurred in 2000 should no longer be necessary due to the increased staffing included in the test year amounts. What that amount should be is unclear; however, our methodology in adopting the test year estimates includes recorded 2002 overtime. We assume that amount and the new positions will cover overtime needs. Lastly, we assume that the new auditor position specifically requested by SCWC is included in our estimates. The increased costs should be more than offset by the specific assignment to Region 3 of the water quality manager and support analyst, who were previously in, and charged to, the general office.

19. Security Plan

In response to the events of September 11, 2001 and ongoing security-related warnings issued by the federal government, SCWC has developed a Security Plan in conformance with industry guidelines and the recently enacted Public Health and Bioterrorism Response Act signed by President Bush into law on June 12, 2002. SCWC indicates that it recognizes the need for increased security and is currently spending capital and O&M funds to that end.

In its application, SCWC included $15,250,193 for GO capital and $809,300 for GO O&M costs for the security plan. Rebuttal testimony revised the amount by spreading the costs over six years. This plan does not alter the cost components of the plan; it only spreads the implementation of the plan over two rate case cycles rather than implementing the entire program in a single year. SCWC's most recent position, as depicted in the Stipulation appendices, incorporates the six-year plan.

ORA opposes the $15.5 million security plan proposed by SCWC. ORA does not oppose increased security per se, but large expenditure and heightened security is an issue that affects all utilities after September 11, and would best be left to a separate proceeding. ORA argues that SCWC has not met the burden of proof for justifying such a large expenditure. ORA recommends the Commission require a separate application on this security plan or open an OII on this issue for water utilities specifically.

As discussed below, we will incorporate the company's six-year plan in the revenue requirement for this GRC cycle.

19.1 Discussion

SCWC is ultimately responsible for the security of its system and we will not interfere with the company's plans to address these important concerns. Our adopted capital expenditures will therefore include security plan amounts to be spent in 2003 and 2004 consistent with the six-year plan proposed by SCWC in Exhibit 42, Exhibit A.

For this application, SCWC has characterized its request to specifically include cost recovery for the following general security measures:[52]

1. The purchase and installation of equipment for detection of intruders.

---

[52] SCWC, Gedney, Exhibit 29.

2. The purchase and installation of fencing, gating, lighting, or security cameras.

3. The re-keying of doors and locks.

4. Improvements to electronic, computer, or other automated systems and remote security systems.

While these appear to be reasonable measures, the reasonableness of SCWC's proposed program scope and estimated costs is somewhat difficult to ascertain. The record does not include the identification and justification of specific elements or projects[53] related to the capital expenditure proposal that is estimated to be over $15 million. Therefore, we recognize that the evidentiary record for these forecasted security related expenditures might not be as detailed as for other capital projects. However, due to the nature of capital cost recovery, we also realize that the majority of the recovery of the security plan capital costs will be based on actual recorded costs that will be used to determine rates in subsequent GRC proceedings. SCWC must be able to demonstrate the reasonableness of the completed elements of the security plan at any time in the future. As such, the company is at risk for cost recovery for completed elements of the plan on a prospective basis.

---

[53] SCWC classified its security plan as confidential and as such details are not provided as part of its direct or rebuttal testimony. A copy of the plan was provided to ORA for its analysis.

We are only authorizing security plan expenditures for Region III, which is the subject of this application, for the years 2003 and 2004 specifically and for the year 2005 by the attrition mechanism. We expect that as the political situation evolves over time, the perceptions of appropriate risk and costs may change. Such change should be incorporated prospectively, to the extent possible. Since, by this decision, GO costs determined in this proceeding will not be allocated to the other regions, those security plan costs will have to be recovered in GRCs for those regions. We expect that the security plan will continue to be evaluated at those times as well as in future GRCs for Region III. That evaluation may include the review of actual expenditures and necessary changes to the plan. If the Commission opens an OII on the subject of water utility security as suggested by ORA, the results of that investigation can be applied prospectively, as appropriate, to SCWC's plan.

20. Customer Information System Software

SCWC included in its 2004 GO capital budget approximately $5.4 million to replace its Customer Information System (CIS) software. SCWC states that the current system is becoming increasingly more costly to operate and less capable of meeting SCWC's needs.

ORA recommends denial of the $5,412,500 CIS funding on the grounds that it had not been properly justified by SCWC. ORA stated that it was not opposed to the replacement of a legacy system with a modern cost effective system. However, the two-sentence justification given for such a large outlay was not sufficient to demonstrate the cost effectiveness of the new system and other efficiencies to be realized. In its rebuttal, SCWC provided additional

information that attempted to describe the problem and the steps to put a new system in place, together with a breakdown of the expected costs to complete. However, SCWC did not provide a cost-benefit analysis that would show the savings in operating efficiencies.

As discussed below, we will not incorporate the company's proposed CIS project in the revenue requirement for this GRC cycle.

20.1 Discussion

We will not include this project in rates at this time because SCWC has not quantified savings associated with the project. By SCWC's own description of the problems with the current CIS, there should be significant savings and efficiencies with a new system, thereby producing savings for the ratepayers, but it has not produced any information to confirm or quantify that proposition. Without that information, it is impossible to develop an opinion on the overall benefits of the project compared to costs and to incorporate appropriate savings in expense or capital forecasts.

This decision to exclude this project at this time does not prohibit SCWC from proceeding with the project at its own risk. If it proceeds on its own, neither the costs nor savings associated with a new CIS would be in rates. That situation would continue until SCWC requests inclusion of the project in a future GRC capital budget and that request is granted. In making any such request, SCWC should address all aspects of the project, including costs, allocation of costs to affiliates and savings.

This issue has also raised a concern regarding SCWC's burden in justifying its request. With the application, SCWC submitted testimony, which included a very brief description of the need for this particular project. After ORA recommended the project be rejected for lack of justification, SCWC provided a more detailed justification in rebuttal testimony. A project of this magnitude, which is in excess of $5 million, requires more attention than what was given by the utility in initially justifying its proposed budgets. Providing the basic justification in rebuttal is unfair, since parties are not generally given the opportunity to respond to rebuttal with testimony of their own. [54] In this case, rebuttal was issued on May 1, 2003 and hearings began on May 12, 2003. The timeframe to conduct discovery on rebuttal, even for the purpose of cross-examination, was limited. When the utility has the evidentiary burden, we caution against the use of rebuttal testimony to provide the basic justification. As a matter of fairness, we must seriously consider either striking such testimony or extending the proceeding, at the utility's risk, to allow for responsive testimony from the other parties.

21. Pensions and Benefits

A major part of the Pensions and Benefits (P&B) cost is for medical insurance premiums. SCWC indicates that in

---

[54] We note that D.89-01-040 (30 CPUC 2d 576) adopted the rate case plan for energy utilities and specifically defines the scope of rebuttal. It states, "Rebuttal evidence shall refute the evidence of other parties and shall not reassert or reargue a party's direct evidence. No bulk or major updating amendments or recorded data shall be allowed in rebuttal evidence." There is no such statement in the current water rate case plan, since it does not specifically provide for rebuttal testimony.

2001, it spent $5,417,307 on P&B expenses, while the recorded expense for 2002 was $7,101,845, a 31% increase. SCWC states it expects to see a 13% increase in medical premiums for 2003/2004. Accordingly, the utility has projected its P&B expense to be $8,085,700 in 2003 and $8,711,800 in 2004.

ORA states that it estimated P&B costs by using 2001 expenses and escalating to 2003 and 2004 using ORA's escalation rates, while SCWC used an annual increase of 28% for health care costs based on some preliminary information it received from a health care provider and approximately a 10% increase for other cost components to derive its estimates. ORA argues that SCWC's proposed increases are excessive, that health care providers often quote higher rates at the beginning of negotiation, and that the projection of these costs is unreasonable. ORA notes that P&B cost has been fluctuating substantially and, in some years, it has actually declined substantially. For instance in 2000, the P&B expense declined 28%. ORA concludes that general inflationary increases are reasonable for the test year estimates.

SCWC argues that ORA's proposal to increase 2001 recorded expenses by less than 3% annually is inadequate to cover the costs that SCWC has already incurred and will incur in the future.

As discussed below, we adopt P&B expense amounts of $7,598,900 for 2003 and $8,130,900 for 2004.

21.1 Discussion

SCWC has provided information that shows its recorded P&B expense for 2002 was $7,101,845. ORA's 2003

estimate, which was based on 2001 recorded information, amounted to $5,261,500. This indicates that significant cost increases, especially in the medical area, are not covered by general inflation. For this reason, it appears reasonable to use the most recent recorded data as the basis for the test year estimates. The 2002 recorded P&B amount of $7,101,845 will therefore be escalated to derive estimates for test years 2003 and 2004. We will consider SCWC's indicated 13% annual increase for medical in determining the appropriate escalation factors. There is also merit in ORA's argument regarding the use of a general inflationary increase due to factors such as fluctuations in historic costs, including significant reductions from one year to the next. Medical costs approximate 40% of the P&B expense. We will weight the 13% projected annual medical increase by that 40% and the annual general inflationary increase of 3% by the remaining 60% of P&B expense. The resultant escalation factor is approximately 7% per year. The 7% annual escalation is applied to the recorded 2002 P&B expense to derive the adopted amounts of $7,598,900 for test year 2003 and $8,130,900 for test year 2004.

22. Reconnection Fees

SCWC Tariff Rule No. 11, paragraph C, subsection 1, addresses the reconnection fee charged when services have been discontinued for violation of CSWC's rules or for nonpayment of the bill. The existing fee is $10 for reconnection during regular working hours or $15 for reconnection when the customer requests that the reconnection be made at other than regular working hours.

SCWC believes that the current fees do not reflect the true cost of the reconnection, and requests that the fees be

raised to $25 for reconnection during regular working hours and $65 for reconnection outside of regular working hours. SCWC indicates that this increase would bring SCWC's reconnection fees in line with the fees California Water Service (CWS) charges its customers for the same service.

In its opening brief, ORA states its opposition to the reconnection fee increase for work done during non-working hours, indicating that the true cost of connection has not been documented. ORA also states that it is not in a position to assess why CWS charges this rate and whether or not it is reasonable.

In response, SCWC states ORA did not submit any testimony opposing SCWC's request to increase its reconnection fee and has no basis to contend that SCWC should not be reimbursed for its actual costs of reconnection.

ORA does not oppose the fee increase from $10 to $25 during working hours, and the increase appears reasonable. We will adopt that increase. Costs for work during non-working hours should be higher, principally for premium pay considerations. While ORA did not submit any testimony on this issue, SCWC still has the burden to demonstrate why its charges are reasonable. In that respect, there is little evidence on the record, other than SCWC's claim that the new charge reflects true costs and is in line with that charged by CWS. The current non-working hour fee is 150% of the current working hour fee, which seems reasonable if overtime pay is necessary. The proposed non-working hour charge is 260% of the proposed working hour charge. The disproportionate increase is questionable and unexplained. We will therefore maintain the current 150% differential in determining the non-working hour charge. Increasing the

proposed $25 working hour charge by 150% results in a fee of $37.50. In the absence of true cost documentation, we will adopt $37.50 as the non-working hour reconnection fee.

23. Comments on Proposed Decision

The proposed decision (PD) was mailed to the parties in accordance with § 311(d) and Rule 77.1. Comments were filed by SCWC, ORA and the City of Claremont on December 12, 2003, and reply comments were filed by SCWC and ORA on December 17, 2003.

23.1 SCWC Comments

SCWC addressed the PD's rejection of portions of the Settlement, rejection of the company's proposal to allocate general office costs to non-GRC districts in this proceeding, treatment of costs imposed by affiliates, reduction to O&M expenses due to the CPP, allocation of revenues from the Folsom lease, recommended return on equity, determination of the supply mix in the Claremont CSA, and adopted level of pensions and benefits expense.

Regarding the rejection of the Settlement's proposed advice letter process for capital recovery, SCWC states that its intent was that there would only be 10 or so advice letter filings associated with the 51 projects. However, whether there would be up to 51 advice letter filings, resulting in a burden on the Commission staff and customer confusion, was only one problem associated with the Settlement proposal. The more general and overriding concern is whether the advice letter procedures are appropriate when considered in the context of test year ratemaking. As the PD states, the proposed advice letter proposal results in after-the-fact cost recovery for capital projects on a recorded cost

basis, which conflicts with the idea of test year ratemaking where reasoned estimates are the basis for rate recovery and where, at least for the rate case period, certain shareholder/ratepayer risks are associated with potential over-spending or under-spending of adopted test year amounts. From this standpoint it is not appropriate to include normal projects that should be handled on an estimated test year basis, through advice letter filings. We see no reason to change the PD's rejection of this process.

The PD also rejected the advice letter process for the Calipatria treatment plant, since the ultimate cost of this large project is unknown. The PD preferred to handle the project through a separate application or in the next GRC, where the reasonableness of the costs can be examined. The PD authorized SCWC to establish a memorandum account with carrying costs equal to the rate of return without gross up for taxes. We do not accept SCWC's comments that the carrying costs should be equal to the pre tax rate of return (grossed up for taxes). When construction work in progress is recovered in rate base on an estimated basis, it would be recovered at the pre tax rate of return. This is appropriate since there is associated revenue, on part of which taxes must be paid. However, accumulating the carrying costs in the memorandum account is similar to an allowance for funds used during construction (AFUDC). AFUDC is not grossed up for taxes, since there is no associated revenue at the time it is incurred. The costs are recovered through depreciation expense and the rate of return on rate base, once the plant is in service. The allowance for taxes on equity funding is made at that time. Similarly, when rates are established for the Calipatria plant, the disposition of the accumulated

carrying costs will be determined. This should include the effect of taxes associated with equity funding.

SCWC also objects to the PD's use of alternative estimates for water supply and conservation projects. SCWC states that the PD discounts SCWC's evidence of the costs of each project simply because SCWC did not submit rebuttal testimony in response to ORA's evidence on each project. SCWC claims it did not submit rebuttal because it had reached a stipulated outcome with ORA before rebuttal was due, and it urges that its estimates should be used for these projects. We disagree. The utility must justify its proposed capital budgets. This should be done in its direct testimony. Additional support can be contained in workpapers, but there should be sufficient information on the record for the Commission to determine need, reasonableness of costs and timing. While the record justifies very little of SCWC's proposed capital budget, we have, for this case, assumed ORA's review of the other projects to which it did not object is sufficient. There are however concerns regarding ORA's adjustments in its direct testimony. Whether or not rebuttal testimony is filed is the company's decision. SCWC did not file rebuttal and, in light of ORA's direct testimony, the record does not support the company's estimates. There is no basis to change the PD on this issue.

Regarding reservoirs, SCWC also questions the PD's timing for two Barstow reservoirs, claiming one should be authorized for 2004 and one for 2005. The PD assumed that those projects would go into service, on average, at the beginning of 2005 (or the end of 2004), the midpoint of the remaining two years in this GRC cycle. This is the same as putting one well into service in mid-2004 and one in mid-2005, which should satisfy SCWC's stated needs.

Regarding the company's proposal to allocate GO costs to non-GRC districts, the PD stated we could not determine the accuracy of the incremental proposal. There is a concern regarding the embedded attrition year amounts for expense and capital in the non-GRC districts. SCWC's direct testimony did not describe how the embedded GO amounts for expense and capital for the non-GRC districts would be determined. Information contained in workpapers, if any, was not made part of the record. In rebuttal testimony, SCWC stated that GO costs are incorporated into their rates reflecting the previously adopted GO costs (from the most recent GRC) adjusted for inflation. However in cross-examination, the witness indicated that the statement might be too general considering the nature of capital budgets as well as specific test year expense adjustments. Whether the embedded attrition year GO expense and capital related costs for the non-GRC districts have been, or can be, appropriately determined has not been demonstrated and we will not change the PD on this issue. We do not preclude future rate case decisions from allocating GO costs to all districts. We only require that any proposed procedure be fully described and documented on the record so that the reasonableness can be determined.

Regarding reimbursement by ASUS for costs incurred by SCWC for services it provides to ASUS, SCWC provides information that shows certain direct labor and overhead charges are already shared by ASUS.[55] However, SCWC

---

[55] In its comments SCWC requests the Commission take notice of its annual reports of affiliated entities and attached the 2002 report. Since these reports are provided to the Commission pursuant to a stipulation

Footnote continued on next page

states that with respect to other costs, ASUS reimburses SCWC by sharing a percentage of the revenues it receives from the contract with SCWC. SCWC further states that, in that way, revenue sharing acts as a proxy calculation for the costs SCWC incurs in providing services to SCWC. It is these other costs that should be directly charged or allocated to ASUS, since the PD concludes that the sharing mechanism is not the appropriate means for ASUS to reimburse SCWC. The cost study ordered by this decision should therefore address the charges or allocations to ASUS for these other costs. The PD's imputed revenue of $101,300 is not a duplicative adjustment. It is a proxy for the amount that should be charged or allocated to ASUS in lieu of the reimbursement by ASUS through the sharing mechanism and amounts to $37,900 more than the estimated $63,400 of sharing revenues proposed by SCWC.

Regarding the PD's CPP adjustment, SCWC's comments maintain that projects deferred in 2001/2002 have been completed in 2003 and no adjustment should be made. SCWC offers to make 2003 recorded information available. However, the record in this proceeding is closed, and an analysis of 2003 recorded information for consideration in this decision is not appropriate without reopening the proceeding. An analysis would have to be done to determine what the deferred costs are and whether any are built into the 2003/2004 estimates for this rate case. The PD addressed the problem of potential recovery of deferred maintenance in

---

adopted by D.98-06-068, we will take notice of the 2002 report, which was the only one provided.

future rate case cycles. The problem of potential windfalls due to balancing account treatment for the BVE costs still remains. In its comments, SCWC suggests that if the PD's proposed adjustment is adopted, the BVE customers should reimburse SCWC for the funds. However, the PD's point is that it was the shareholders, not the electric customers, who benefited from the water utility (as well as certain electric utility) deferrals. No change to the PD's CPP adjustment is warranted.

Regarding the Folsom Lease issue, SCWC reargues its points regarding the PD's classification of the lease as utility property. We see no error[56] in the PD's conclusion that water rights are an essential element of operating a water utility; those rights can be "enjoyed" even if they are not immediately exercised, the original water rights were therefore utility property and the remaining water rights continue to be utility property under the jurisdiction of this Commission.

Regarding return on equity, we find no reason to change the conclusions reached in the PD. SCWC's comments reargue its position on risk associated with the balancing account rulemaking. Based on the principles contained in D.03-06-072, those arguments were considered and rejected by the PD. There is no need to address them again. New

---

[56] Rule 77.3 states that comments shall focus on factual, legal or technical errors in the proposed decision and in citing such errors shall make specific references to the record. Comments which merely reargue positions taken in briefs will be accorded no weight and are not to be filed.

information attached to SCWC's comments is untested by cross-examination, inconclusive and will not be considered in this decision. Regarding regulatory risk, SCWC is correct in pointing out that the PD's reference to the acceptance of the advice letter process for the 51 capital projects is wrong and should not be reflected in the related discussion. That reference will be corrected.

Regarding the supply mix in the Claremont CSA, we see no reason to lower the amount of pumped water supply below what was achieved in 2002. SCWC's comments point out that the PD acknowledges that the two new wells, planned in 2003 and 2004 would replace and not provide additional water supply, but defers the two new wells into 2005. SCWC states that to correct this discrepancy, either the wells should be put into service in 2003 and 2004 as requested or SCWC's lower pumping amount should be adopted. We do not consider this to be a discrepancy. The importance of the assumption that the two new wells would be used to replace rather than supplement the pumped water supply was that it justified not increasing the amount of pumped water beyond that already achieved by SCWC in 2002. For the well and reservoir projects that would be recovered directly in rates by this decision rather than through the advice letter process, the PD assumed that those projects would go into service, on average, at the beginning of 2005 (or the end of 2004), the midpoint of the remaining two years in this GRC cycle. Exactly when the Claremont CSA wells go into service is entirely at the discretion of SCWC, and we assume that will occur when the wells are needed.

Regarding P&B expenses, SCWC states that the PD excludes $269,133 for 2003 and $303,388 for 2004 to

provide for medical and dental expenses for 14 now-filled GO positions. However, in determining the composite 7% annual P&B escalation rate over 2003 recorded amounts, the PD incorporated the approximate 13% per year increase beyond the recorded 2002 amounts for medical and dental that was advocated by SCWC and used in determining its updated medical and dental estimates. In essence, the PD adopted SCWC's medical and dental expense request, and it is assumed that any employee growth estimated by the SCWC is included in those amounts.

SCWC indicated that certain corrections should be made to the appendices of the PD. Those items were reviewed and appropriate changes have been incorporated in this decision.

23.2 ORA Comments

ORA requests that the PD be modified to clarify that SCWC should offset the water quality memorandum accounts with any payment by the polluters for the water contamination. The purpose of these accounts is to accumulate the net costs of meeting potential new water quality requirements for five specific contaminants. To the extent that there are reimbursements by other entities directly related to the projects and costs being accumulated in the memorandum accounts, it is reasonable to include those reimbursements as offsets to the compliance costs. The ordering paragraph will be modified to reflect this.

ORA pointed out a technical error that has been incorporated in this decision.

23.3 City of Claremont Comments

The City of Claremont addressed the issue of regional rates by recommending that the PD be put aside until the

validity of regional rates is resolved. This recommendation will not be adopted, since the PD resolved the validity in concluding that regional rates should be continued.

24. Comments on Alternate Proposed Decision

The Alternate Proposed Decision of Commissioner Lynch to the Proposed Decision was mailed on January 28, 2004. Opening comments were filed by SCWC. No reply comments were filed.

For the most part, SCWC's comments repeat arguments previously considered in the preparation of the alternate proposed decision. For example, SCWC repeats its contention that the water rights leased to Folsom were not "useful" pursuant to § 851 because the portion of those rights subject to the lease had not previously been used by SCWC. However, SCWC fails to acknowledge that water rights can be "enjoyed"[57] and be useful even if not presently used. The fact that, in 1994, SCWC would need to build additional water treatment facilities to take advantage of those water rights did not render the rights useless. As facts subsequent to 1994 have shown, SCWC always had the option to build such facilities in order to capitalize upon the useful water rights in its possession.SCWC also points out that, when it previously transferred 22,000 AFY of water rights to Folsom in 1966, the Commission issued a decision, D.71889, finding that SCWC did not need those water rights to serve its customers. This point only serves to support our decision today. In 1966, SCWC took the required step under § 851 of

---

[57] *Camp Meeker*, 33 CPUC 2d at 296.

seeking Commission approval for the transfer of its water rights. In 1994, § 851 continued to require advance approval for the transfer of additional water rights to Folsom. The fact that the Commission had 18 years earlier found the water rights unnecessary to serve customers did not eliminate the statutory requirement to gain Commission pre-approval for the lease in perpetuity of useful water rights. SCWC was right in seeking advance approval in 1966, but seriously erred in not doing the same in 1994.

SCWC misconstrues today's decision in claiming that the decision "argues that SCWC should have retained the water rights it allocated to Folsom . . .." [58] We reach no such conclusion. Rather, our holding is that § 851 required SCWC to seek a Commission decision as to whether its lease of water rights was appropriate. We hazard no opinion as to what the outcome of a timely § 851 application would have been. But what is clear is that SCWC's failure to make this required request deprived us of the opportunity to address significant issues presented by the lease.

SCWC contends that ratepayers did not pay for the water rights that SCWC acquired from Natomas Water Company (Natomas) "in any fashion."[59] The record does not support this contention. In addition to the facts cited above, we note that the contract for the sale of Natomas to SCWC defined the "Property" that was sold to include "[a]ll water and water rights both *surface* and subsurface (including inchoate rights

---

[58] SCWC Comments at 6.

[59] SCWC Comments at 6.

and undivided interests and rights) owned or claimed by Seller on the Closing Date . . .."[60] In addition, the contract identified such water rights as among the properties that were "used by or useful to Seller" and were included in the overall "Property" that was being sold under the agreement.[61] Thus, the water rights at issue were part of the property that was exchanged for value in the sale of Natomas to SCWC. In addition, the language of the agreement itself contradicts SCWC's claim that the water rights were not useful.

The contract language provides a further reason for rejecting SCWC's argument that it properly accounted for the water rights and the lease proceeds as non-utility property. The water rights were part of the utility property transferred upon the sale and were explicitly characterized as among the used or useful property being sold.

25. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and David Fukutome is the assigned ALJ in this proceeding.

26. Timing

Because this filing requests rates for test year 2003, this decision should be made effective immediately.

---

[60] Ex. 56, § 1.01 (italics added).

[61] *Id.*

Findings of Fact

1. The Stipulation includes 51 individual capital projects that are subject to advice letter filings and rate adjustment.

2. The filing of as many as 51 advice letters would be an administrative burden on the Commission staff.

3. The implementation of as many as 51 individual rate changes would cause ratepayer confusion and concern.

4. The need for the San Gabriel well has not been substantiated, and it will not be included in plant estimates for this GRC.

5. The appropriate estimated cost of the Lucerne Valley well, the San Dimas well, two Orange County wells, two Claremont wells and two Barstow wells is $3,517,230, or 63.7% of the costs estimated by SCWC. On average, the estimated operational date for the wells is January 1, 2005.

6. The need for the Orange County reservoir has not been substantiated, and it will not be included in plant estimates for this GRC.

7. The appropriate estimated cost of the two Barstow reservoirs is $1,130,000. On average, the estimated operational date for the reservoirs is January 1, 2005.

8. The reasonableness of the conservation capital budget has not been demonstrated, and those projects will not be included in plant estimates for this GRC.

9. Our resolution of the CPP issue results in a maintenance expense estimate that differs from the Stipulation amounts.

10. Affordability is a primary consideration in this proceeding as it was in A.98-09-040 where SCWC requested single tariff pricing for its Region III.

11. Regional rates effectively addresses the problem of affordability for high rate districts in SCWC's Region III.

12. The record in this case does not detail how incremental GO allocations for non-GRC districts would be determined.

13. Incremental GO allocations are not necessary under ORA's GO allocation proposal where the allocation is determined for each rate case.

14. SCWC and ASUS are subsidiaries of American States Water Company.

15. Through the CPP, SCWC customers paid, in part, for BVE purchased energy costs.

16. Through the balancing account procedure for costs incurred in 2001 and 2002, BVE will eventually be made whole for the appropriate and reasonable amount of purchased power costs.

17. On a company-wide basis, for the period in which the CPP was in effect, SCWC's actual O&M spending was $3.6 million below authorized levels.

18. On a company-wide basis, SCWC's actual capital expenditures were $39 million for 2001 and $45 million for 2002; the amounts previously authorized by the Commission were $37 million for 2001 and $42 million for 2002.

19. The Region III recorded maintenance expense is $2,807,800 for 2001 and $3,307,00 for 2002.

20. When compared to amounts previously authorized by the Commission, the level of SCWC's capital spending was largely unaffected by the CPP. Therefore, for purposes of determining the effect of the CPP on SCWC's operations, it is reasonable to assume the majority of the effect relates to O&M expenses.

21. Based on the stipulated 2003 maintenance expense for Region III, reasonable estimates of maintenance expense that should have occurred in 2001 and 2002 are $3,556,100 and $3,616,200 respectively.

22. On an industry-wide basis, the adopted sales per customer are currently used for calculating revenues for the earnings test.

23. ORA's proposal to use weather-adjusted sales for the earnings test that is used to justify step and attrition increases is a change in an industry-wide policy that would affect all large water utilities.

24. Costs related to water quality requirements are difficult to forecast, until the appropriate authority or agency specifies the requirements.

25. SCWC presented its water quality record from March 1998 to December 2002, updating the data previously presented in I.98-03-013. No party disputed that information.

26. Although assigned no itemized value, 32,000 AFY in water rights were included in the purchase of the Natomas Water Company by SCWC in 1964.

27. SCWC's Folsom water system and 22,000 AFY of water rights were transferred to the City of Folsom in 1967.

28. In 1994, SCWC agreed to lease 5,000 AFY of water to the City of Folsom. The lease was indefinite and included no termination rights for SCWC.

29. SCWC has recorded all revenues from the Folsom lease in a non-operating below-the-line account that benefits only shareholders.

30. The entire cost of the Natomas Water Company purchase, which included the right to 32,000 AFY of American River water, was borne by the ratepayers. Shareholders were not separately responsible for the recovery of any of the costs.

31. SCWC has a future need for American River water rights that exceeds 10,000 AFY.

32. An update of DRI forecasts shows new issue coupon rates of 6.63% for 2003 and 8.47% for 2005.

33. For new debt, ORA calculates effective interest rates of 6.76% for 2003 and 8.62% for 2005.

34. Based on more recent information, it is reasonable to adopt the ORA forecast of the average cost of debt of 7.67% in 2003, 7.63% in 2004 and 7.68% in 2005.

35. Past rate of return authorizations for SCWC and authorizations for other Class A water utilities under Commission jurisdiction do not reflect the market to book adjustment proposed by SCWC.

36. SCWC's CAPM analysis includes data related to companies other than regulated water companies.

37. SCWC's Fama-French Three Factor Model, which has never been adopted for use by this Commission, is similar to the CAPM.

38. Since we have previously determined that water companies should not be compared to companies in other industries, we will not incorporate the results of the CAPM or the Fama-French Three Factor Model, as calculated by SCWC.

39. The inclusion of Artesian Resources in ORA's group of comparable companies results in ORA's DCF analysis yielding a return of 8.35% and the RP analysis yielding a return of 10.52%.

40. Based on the DCF and RP model analyses performed by SCWC and ORA (with the inclusion of Artesian Resources in ORA's comparable group), a reasonable ROE range is 9.08% to 10.70%.

41. After considering evidence regarding SCWC's financial, business and regulatory risk, it is reasonable to authorize an equity return that is in the middle of the range. The resulting return of 9.90% and our adopted debt costs equate to a rate of return on rate base of 8.79% for test year 2003, 8.77% for 2004 and 8.79% for attrition year 2005.

42. Regulatory mechanisms such as balancing accounts for purchased water, purchased power and pump taxes; memorandum accounts for catastrophic events; memorandum accounts for SDWA compliance; 50% fixed cost recovery; construction work in progress in rate base and advice letter recovery of certain capital projects are in place and mitigate business risk associated with the capital intensive nature of water utilities and operating leverage concerns where a utility relies on higher than average quantities of purchased water.

43. D.03-06-072, which was issued subsequent to SCWC's application filing, addresses issues related to revised procedures for recovery of under collections and over collections in balancing accounts.

44. D.03-06-072 corrects an imbalance in the risks associated with previous balancing account procedures. Specifically, it eliminates the opportunity for unanticipated windfalls caused by balancing account protection.

45. For the purpose of forecasting commercial sales, past Commission policy statements have encouraged the use of a monthly regression model as opposed to the Modified Bean method.

46. SCWC's monthly regression method for forecasting commercial sales yields statistically significant results.

47. ORA's Modified Bean method for forecasting commercial sales failed the F-statistic and the Durbin-Watson tests of statistical significance.

48. For the Claremont CSA, the recorded information for the years 2000–2002, indicates significantly less pumped water than for the years 1997-1999.

49. For the Claremont CSA, the recorded 2002 groundwater production of 2,328,374 Ccf is higher than the 2001 recorded amount of 2,130,617 Ccf and very close to the 2000 recorded amount of 2,389,100 Ccf.

50. Since the groundwater production in the Claremont CSA has leveled off over the last three recorded years, it is reasonable to use the 2002 recorded amount of 2,328,374 Ccf as the estimated pumped water quantity for this CSA, for both test year 2003 and 2004.

51. SCWC's forecasted supply cost increase for 2004 is unsubstantiated and conflicts with D.03-06-072.

52. A review process for increasing supply costs is set forth in D.03-06-072.

53. For general office labor, the recorded expense for 2002 is $6,002,175.

54. The expense for general office labor, related to 14 vacant positions in 2002, is $740,700.

55. A reasonable test year estimate for general office labor is the recorded 2002 amount increased by the expense related to 14 positions that were vacant in 2002, escalated to 2003 and 2004 by the adopted labor escalation factors.

56. General office overtime levels for 2000 are accounted for in the 2003 and 2004 estimates, specifically by the inclusion of 14 additional positions and implicitly through the use of the 2002 recorded amount, which includes some amount of overtime, as the base for the test year estimates.

57. SCWC proposes a six-year phase-in of its security plan.

58. SCE has not produced any information to confirm or quantify its assertion that the proposed CIS will be less labor intensive and more efficient, thereby producing savings for the ratepayers.

59. The recorded P&B expense for 2002 is $7,101,845.

60. For the test year estimates of P&B expense, the recorded 2002 amount of $7,101,845 should be escalated to 2003 and 2004 amounts. For P&B escalation, an annual medical escalation factor of 13% should be weighted by 40% and an annual general escalation factor of 3% should be

weighted by 60%, resulting in annual escalation of 7%. The resultant test year estimates for P&B expense are $7,598,900 for 2003 and $8,130,900 for 2004.

61. The true cost of reconnection during non-working hours has not been substantiated by SCWC.

62. It is reasonable to maintain a 150% differential between the working hour reconnection fee and the non-working hour reconnection fee. The resulting fee for reconnection during non-working hours is $37.50.

Conclusions of Law

1. It is reasonable to allow SCWC to accrue capital costs related to the Calipatria treatment plant project in a memorandum account. SCWC can recover the costs of the project in a separate application or as part of the next GRC for Region III.

2. Other than the Calipatria treatment plant project, capital projects associated with proposed advice letter procedure contained in the Stipulation should be considered for rate recovery on an estimated GRC basis.

3. With the exception of the advice letter procedure for capital projects and the maintenance expense forecast, the Stipulation is reasonable and in the public interest and should be adopted.

4. Since affordability continues to be a problem and regional rates effectively address that problem, regional rates should not be altered at this time.

5. Since there may be viable alternatives to regional rates, parties should have the opportunity to address the subject in SCWC's next Region III GRC.

6. SCWC should continue to provide annual reports on regional rates as ordered and described in D.00-06-075. Reports should be served on all appearances in this proceeding.

7. Since concerns regarding the implementation of SCWC's incremental cost proposal for allocation of GO costs to non-GRC districts are not addressed in the record of this proceeding, the company's request to allocate GO costs determined in this GRC to non-GRC districts should be denied.

8. ORA's proposal to determine GO allocations in each GRC should be adopted, since this methodology has been used in the past and does not require the same incremental determination of step and attrition year rates as does SCWC's proposal.

9. D.98-06-068 specifies policies and guidelines for transactions between SCWC, the holding company and affiliates.

10. The affiliate transaction policies and guidelines specified in D.98-06-068 should be applied to SCWC's dealings with ASUS.

11. For contemplated dealings with ASUS in this GRC, SCWC has not applied the affiliate transaction policies and guidelines specified in D.98-06-068.

12. In lieu of an affiliate cost study for this GRC, it is reasonable to assign $101,300 as affiliate related costs to be deducted from the GO revenue requirement.

13. For the future, SCWC should prepare a cost study and analysis, in order to fairly assign and allocate costs related to

its affiliates, in accordance with the policies and guidelines specified in D.98-06-068.

14. SCWC customers should be reimbursed, in some manner, for the cash that was diverted from the water operations, due to the CPP. To do otherwise would result in a windfall for shareholders.

15. For this GRC cycle, shareholders should be responsible for $352,200 of the annual Region III maintenance expense contained in the Stipulation.

16. ORA's proposal to use weather adjusted recorded sales per customer, for calculation of revenues in the earnings test, is a change in an existing industry-wide policy. It would be more appropriate and fair to consider the intent of the earnings test in a proceeding with all affected parties having the opportunity to participate.

17. Due to the manner in which this decision treats the Stipulation's proposed advice letter procedure for capital projects, SCWC's proposal to include the proposed 2003 and 2004 advice letter projects in the determination of the 2005 attrition year increase should be denied.

18. SCWC's request for memorandum account treatment for the costs to comply with MTBE, perchlorate, NDMA, radon and arsenic contamination is reasonable.

19. SCWC's request to amortize the Water Quality OII memorandum account accumulation, over a 12-month period, as a special condition surcharge applied to the quantity rate throughout the company, is unopposed and reasonable.

20. The water rights leased to the City of Folsom beginning in 1994 were "useful", as that term is used in §

851, because they enhanced SCWC's ability to meet future water supply contingencies.

21. SCWC's failure to file a § 851 application has prevented the Commission from assessing whether the lease in perpetuity of the water rights could have an adverse impact on ratepayers by undermining SCWC's ability to respond to water supply contingencies. Had SCWC filed an application, the Commission could have considered imposing conditions on the proposed lease, such as requiring the lease to be for a definite term or requiring that SCWC have termination rights as necessary to protect the interests of ratepayers.

22. SCWC's failure to file a § 851 application prevented the Commission from passing judgment on SCWC's unilateral determination to place the lease revenues in a below-the-line account solely for the benefit of shareholders.

23. By failing to file a § 851 application, SCWC prevented the Commission from considering any environmental impacts associated with the transfer of water rights and whether any whether mitigations needed to be ordered.

24. Since water rights were included in the transaction wherein SCWC acquired the assets of the Natomas Water Company, water rights are an essential element of operating a water company, and the Commission has previously determined that property rights can be "enjoyed" even if they are not immediately exercised, the entire amount of water rights acquired in 1964 was utility property. Since 22,000 AF of the original 32,000 AF entitlement has been transferred to the city of Folsom, SCWC's remaining 10,000

AF of water rights should be considered utility property under the jurisdiction of this Commission.

25. Because SCWC's remaining 10,000 AFY of water rights , including the 5,000 AFY leased to the City of Folsom, were useful in the performance of SCWC's duties to the public, the utility was required to seek Commission authorization under the provisions of § 851 in order to lease that 5,000 AFY to the City of Folsom.

26. SCWC violated § 851 when it failed to gain the Commission's approval prior to effectuating the Folsom lease.

27. Under § 851, as to SCWC, the Folsom lease is void from its inception.

28. Under § 851, the City of Folsom's past use of and payments for the leased water rights are unaffected by the voiding of the lease as to SCWC.

29. The prospective impact of the voiding of the lease on the City of Folsom has not been addressed by the parties.

30. Because ratepayers have borne the cost of obtaining the water rights that were leased to the City of Folsom, it is reasonable to allocate 70% of the benefits of the lease to ratepayers from the inception of the lease until the date of this decision.

31. Under the "continuing violation" language of § 2108, the period of SCWC's violation totals at least 2,190 days.

32. SCWC's violation of § 851 was a severe offense that harmed ratepayers and the regulatory process.

33. Based on the record in this proceeding, the market to book adjustment proposed by SCWC is not necessary at this time.

34. An equity return premium based on the reasons advocated by SCWC would not be reasonable.

35. Since the monthly regression method used by SCWC, to forecast commercial sales, produces results that are statistically more significant than that produced by ORA's Modified Bean method and is consistent with the stated policy of the Water Division and Commission decisions, we should adopt SCWC's estimates for commercial sales per customer.

36. Rather than forecasting supply cost increases, such increases should be authorized through the review process adopted in D.03-06-072.

37. SCWC's request for a 1.5% equity adjustment for general office labor is unsubstantiated and should not be adopted.

38. SCWC's proposal to phase in its security plan over six years is reasonable and should adopted.

39. The security plan should be reevaluated in subsequent GRC filings. Appropriate changes to the plan should be made and reflected in rates on a prospective basis.

40. In order to include the CIS project in rates, justification for the project should address need, costs, allocation of costs to affiliates and savings.

41. Since SCWC has not provided estimated savings related to the CIS project, the reasonableness of the project and the net costs to be included in rates cannot be

determined. The costs and the savings related to the CIS project should therefore be excluded from rates determined in this decision.

42. SCWC's proposed fee of $25 for reconnection during working hours is not opposed and should be adopted.

43. Today's order should be made effective immediately.

ORDER

IT IS ORDERED that:

1. Southern California Water Company (SCWC) is authorized to file in accordance with General Order 96-A, and to make effective on not less than five days' notice, the revised tariff schedules for 2003 included as Appendices B and G to this order. The revised tariff schedules shall apply to service rendered on and after their effective date.

2. Advice letters for authorized rate increases for 2004 and 2005 shall be filed in accordance with General Order 96-A, no earlier than November 1 of the preceding year. The filing shall include appropriate work papers. The increase shall be the amount authorized herein, or a proportionate lesser increase if SCWC's rate of return on rate base, adjusted to reflect rates then in effect, normal ratemaking adjustments, and the adopted change to the pro forma test, for the 12 months ending September 30 of the preceding year, exceeds the lower of (a) the rate of return on rate base found reasonable by the Commission for SCWC for the preceding year in the then most recent rate decision, or (b) the return on rate base authorized herein for the preceding year. The advice letters shall be reviewed by the Water Division for conformity with this decision, and shall go into effect upon Water Division's determination of compliance, not earlier than January 1 of the year for which the increase is authorized, or 30 days after filing, whichever is later. The tariffs shall be applicable to service rendered on or after the effective date. The Water Division shall inform the Commission if it finds the proposed increase does not comply with this decision or other Commission requirements.

3. SCWC is authorized to establish a memorandum account to accrue the costs of the Calipatria treatment plant project, with carrying costs computed using the authorized rate of return, without gross-up for taxes. SCWC may seek cost recovery through a separate application or as part of the next Region III GRC.

4. SCWC is authorized to file an advice letter to modify the preliminary statement in its tariffs to describe and to, after the 30 day statutory timeframe, establish a memorandum account to accumulate the costs to comply with MTBE, perchlorate, NDMA, radon and arsenic contamination remediation requirements. Cost recovery shall be net of any previous expenses that were authorized to comply with previous remediation requirements that have been superseded, as well as any reimbursements directly related to the projects and costs being accumulated in the memorandum accounts.

5. SCWC is authorized to establish a special condition surcharge to be applied to the quantity rate throughout SCWC's service territory, to amortize the Water Quality OII memorandum account accumulation. The accumulated amount, at the time of this decision, shall be amortized over a 12-month period.

6. SCWC shall conduct a cost study and analysis that shall be the basis for assigning and allocating costs related to its affiliates. The cost study shall reflect the principles, policies and guidelines in Decision 98-06-068. SCWC shall address each point in the holding company settlement that applies to affiliate transactions and costs, and shall show the effect, on both affiliate and utility costs, of implementing appropriate measures to comply with that settlement. SCWC

shall include the study and incorporate the results in its next Region III GRC application. SCWC shall also adopt appropriate management policies and accounting practices to ensure that the terms of the holding company settlement are fully implemented.

7. With respect to the Arden-Cordova CSA, as to SCWC, the 1994 lease of water rights to Folsom is void from its inception pursuant to § 851. However, pursuant to the second paragraph of § 851, Folsom's use of and payments for the leased water rights in the past are unaffected by the voiding of the lease as to SCWC.

8. With respect to the Arden-Cordova CSA, within 30 days of the issuance of this decision, SCWC shall either file an application for prospective approval of a lease of water rights to Folsom or file a pleading stating that it does not wish to lease water rights to Folsom and will not make such rights available to Folsom any longer. If SCWC files an application, it shall comply with all applicable rules of the Commission's Rules of Practice and Procedure.

9. With respect to the Arden-Cordova CSA, within 30 days of the issuance of this decision, SCWC shall file and other parties may file a brief that addresses the rights of Folsom in each of the following circumstances: (1) SCWC seeks and obtains § 851 approval for a prospective lease to Folsom; (2) SCWC chooses not to pursue a prospective lease to Folsom and hence does not file a § 851 application; or (3) SCWC seeks § 851 approval of a prospective lease, but the request is denied. The City of Folsom is specifically invited to brief these issues if it so desires. The assigned administrative law judge shall fix the time for the filing of reply briefs on these issues.

10. With respect to the Arden-Cordova CSA, SCWC shall file an advice letter within 20 days of the issuance of this decision that calculates 70% of the total lease revenues that SCWC has accrued from the Folsom lease from the inception of the lease through the effective date of this decision, plus 7% interest. The advice letter should also propose a method for crediting this total amount on ratepayer bills in an equitable fashion. This advice letter will be subject to protest in accordance with General Order 96-A.

11. A penalty of $1,095,000 is assessed for continuing violations of Public Utilities Code § 851. However, at this time, $915,000 of that penalty amount is suspended. SCWC shall pay $180,000 to the State of California General Fund within ten days of the date of issuance of this decision. Proof of payment shall be filed and served on the service list and shall be provided to the Director of the Water Division within five days of payment.

This order is effective today.

Dated March 16, 2004, at San Francisco, California.

CARL W. WOOD
LORETTA M. LYNCH
GEOFFREY F. BROWN
Commissioners

I dissent.

/s/ MICHAEL R. PEEVEY
President

I reserve the right to file a concurrence.

/s/ GEOFFREY F. BROWN
Commissioner

I reserve the right to file a dissent.

/s/ SUSAN P. KENNEDY
Commissioner

P.U.C. Nos. 04-03-039/04-04-069/04-09-028
S128422

IN THE SUPREME COURT OF CALIFORNIA

En Banc

SOUTHERN CALIFORNIA WATER COMPANY,
Petitioner,

v.

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Respondent.

Petition for writ of review DENIED.

Supreme Court
FILED
FEB 16 2005
Frederick K. Ohlrich
Deputy Clerk

GEORGE
Chief Justice

(2)

No. 04-1547

OFFICE OF THE CLERK

In The

Supreme Court of the United States

SOUTHERN CALIFORNIA WATER COMPANY,

Petitioner,

v.

CALIFORNIA PUBLIC UTILITIES COMMISSION,

Respondent.

On Petition For Writ Of Certiorari To The California Supreme Court

BRIEF FOR THE RESPONDENT CALIFORNIA PUBLIC UTILITIES COMMISSION IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

RANDOLPH L. WU
ANNE K. MESTER
ELEANOR M.W. YOUNGSMITH*
**Counsel of Record*

PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA
505 Van Ness Avenue
San Francisco, CA 94102
Telephone: (415) 703-2088

Counsel for Respondent

COCKLE LAW BRIEF PRINTING CO (800) 225-6964
OR CALL COLLECT (402) 342-2831

QUESTION PRESENTED

Whether the California Public Utilities Commission correctly found that a regulated public utility cannot disregard state regulatory law and transfer, without authorization and to the disadvantage of its customers, public utility property already dedicated to public use and necessary and useful to the utility's public service.

TABLE OF CONTENTS

	Page
Table of Authorities	iii
Statutory Provision	2
Opposition of the California Public Utilities Commission to the Petition for a Writ of Certiorari	1
This Court Lacks Jurisdiction	1
Preliminary Statement	3
Statement of the Case	6
1. Background	6
2. Petitioner's acquisition of the public utility property	7
3. Petitioner's first transfer of a portion of the property	7
4. Petitioner's second transfer of a portion of the remaining property	8
Reasons for Denying the Petition	11
1. There is no taking because the water right has always been dedicated to the public benefit and useful to the petitioner and its predecessors in serving the public	13
2. Petitioner's dedication argument is based on arbitrary assumptions and a complete disregard of the facts	15
Conclusion	16

TABLE OF AUTHORITIES

Page

CASES

City of San Francisco v. Public Utilities Comm'n, 39 Cal. 3d 523 (1985) 11

Greyhound Lines, Inc. v. Public Utilities Comm'n, 68 Cal. 2d 406 (1968) 2

Market St. R. Co. v. R.R. Comm'n, 24 Cal. 2d 378 (1944), *aff'd*, 324 U.S. 548 (1945) 2

People v. Murrison, 101 Cal. App. 4th 349 (2002), *review denied*, 2002 Cal. LEXIS 7988 (Nov. 20, 2002) 13

Richfield Oil Corp. v. Public Utilities Comm'n, 54 Cal. 2d 419 (1960), *cert. denied sub nom. Southern Counties Gas Co. v. Public Utilities Comm'n*, 364 U.S. 900 (1960) 16

Southern California Edison Co. v. Peevey, 31 Cal. 4th 781 (2003) 6

Southern California Gas Co. v. Public Utilities Comm'n, 23 Cal. 3d 470 (1979) 11

Toward Utility Rate Normalization v. Public Utilities Comm'n, 22 Cal. 3d 529 (1978) 2

United States v. State Water Resources Control Bd., 183 Cal. App. 3d 82 (1986) 13

Western Canal Co. v. R.R. Comm'n of Cal., 216 Cal. 639 (1932), *cert. denied*, 289 U.S. 742 (1933) 2

Yucaipa Water Co. No. 1 v. Public Utilities Comm'n, 54 Cal. 2d 823 (1960) 11

TABLE OF AUTHORITIES – Continued

Page

ADMINISTRATIVE DECISIONS

In re Southern Cal. Water Co., Cal. Pub. Util. Comm'n Decision No. 04-09-028, slip opinion (March 16, 2004) ..... *passim*

In re Southern Cal. Water Co., Cal. Pub. Util. Comm'n Decision No. 04-04-069, slip opinion (April 22, 2004) 1, 10, 13

In re Southern Cal. Water Co., Cal. Pub. Util. Comm'n Decision No. 04-03-039, slip opinion (September 2, 2004) ..... *passim*

In re Southern Cal. Water Co. and City of Folsom, Cal. Pub. Util. Comm'n Decision No. 71889, slip opinion (January 24, 1967) ..... *passim*

In re Natomas Water Co. and Southern Cal. Water Co., Cal. Pub. Util. Comm'n Decision No. 67299, slip opinion (June 3, 1964) 7, 11, 14

CONSTITUTIONAL PROVISIONS

U.S. Const. amend. XIV 4

Cal. Const. art. XII, § 1 1

Cal. Const. art. XII, § 3 12

STATUTES

28 U.S.C. § 1257 1

Cal. Pub. Util. Code § 216 12

Cal. Pub. Util. Code § 307 1

Cal. Pub. Util. Code § 702 12

Cal. Pub. Util. Code § 851 ..... *passim*

TABLE OF AUTHORITIES – Continued

Page

Cal. Pub. Util. Code § 1756 11

Cal. Pub. Util. Code § 1757.1 ..... 6, 11

Cal. Pub. Util. Code § 2106 12

Cal. Pub. Util. Code § 2107 12

OTHER AUTHORITIES

Cal. Pub. Util. Comm'n Rules of Practice and Procedure, rule 1 12

Cal. Pub. Util. Comm'n Rules of Practice and Procedure, rule 85 11

OPPOSITION OF THE CALIFORNIA PUBLIC UTILITIES COMMISSION TO THE PETITION FOR A WRIT OF CERTIORARI

The Public Utilities Commission of the State of California (hereinafter CPUC), respectfully opposes the petition for a writ of certiorari.[1]

THIS COURT LACKS JURISDICTION

Petitioner does not contend the state statute at issue is invalid or repugnant to the laws of the United States. 28 U.S.C. § 1257. Petitioner has not argued to this Court or below that the evidentiary findings and conclusions in the underlying CPUC decision, as modified, are not based on substantial evidence. Rather, petitioner contends it does not have to comply with the procedural requirements of relevant state law. By arguing that the CPUC's application of the pertinent state statute to petitioner's specific facts

[1] Petitioner names the CPUC as respondent to the petition for a writ of certiorari to the California Supreme Court. The state supreme court summarily denied petitioner's petition for writ of review of *In re Southern Cal. Water Co.*, Cal. Pub. Util. Comm'n Decision No. 04-03-039, slip op. (March 16, 2004) (hereinafter referred to as "D.04-03-039"), as modified by *In re Southern Cal. Water Co.*, Cal. Pub. Util. Comm'n, Decision No. 04-04-069, slip op. (April 22, 2004) (hereinafter referred to as "D.04-04-069") and *In re Southern Cal. Water Co.*, Cal. Pub. Util. Comm'n Decision No. 04-09-028, slip op. (September 2, 2004) (hereinafter referred to as "D.04-09-028"). The CPUC is a constitutionally created state agency and its attorney is required to represent and appear for the People of the State of California and the CPUC in all actions and proceedings involving any question concerning the Public Utilities Act or any order or act of the CPUC. Cal. Const. art. XII § 1; Cal. Pub. Util. Code §307.

deprives it of private property, petitioner asks this Court to substitute its independent judgment on the law and facts, an improper role for this Court to assume.[2] The petition should be denied.

STATUTORY PROVISION

CALIFORNIA PUBLIC UTILITIES CODE SECTION 851

§ 851. No public utility other than a common carrier by railroad subject to Part I of the Interstate Commerce Act (Title 49, U.S.C.) shall sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or any part of its railroad, street railroad, line, plant, system, or other property necessary or useful in the performance of its duties to the public, or any franchise or permit or any right thereunder, nor by any means whatsoever, directly or indirectly, merge or consolidate its railroad, street railroad, line, plant, system, or other property, or franchises or permits or any part thereof, with any other public utility, without first having secured from the [CPUC] an order authorizing it so to do. Every such sale, lease, assignment, mortgage, disposition, encumbrance, merger, or consolidation made other than in

[2] "There is a strong presumption favoring the validity of a Commission decision." *Toward Utility Rate Normalization v. Public Utilities Comm'n*, 22 Cal. 3d 529, 537 (1978); *Market St. R. Co. v. R.R. Comm'n*, 24 Cal. 2d 378, 399 (1944), *aff'd*, 324 U.S 548 (1945); *Western Canal Co. v. R.R. Comm'n of Cal.*, 216 Cal. 639, 645 (1932), *cert. denied*, 289 U.S. 742 (1933). "[T]he [CPUC's] interpretation of the Public Utilities Code should not be disturbed unless it fails to bear a reasonable relation to statutory purposes and language [citations omitted]." *Greyhound Lines, Inc. v. Public Utilities Comm'n*, 68 Cal. 2d 406, 410-411 (1968); *Western Canal Co., supra* 216 Cal. at 645.

accordance with the order of the [CPUC] authorizing it is void. The permission and approval of the [CPUC] to the exercise of a franchise or permit under Article 1 (commencing with Section 1001) of Chapter 5 of this part, or the sale, lease, assignment, mortgage, or other disposition or encumbrance of a franchise or permit under this article shall not revive or validate any lapsed or invalid franchise or permit, or enlarge or add to the powers or privileges contained in the grant of any franchise or permit, or waive any forfeiture.

Nothing in this section shall prevent the sale, lease, encumbrance or other disposition by any public utility of property which is not necessary or useful in the performance of its duties to the public, and any disposition of property by a public utility shall be conclusively presumed to be of property which is not useful or necessary in the performance of its duties to the public, as to any purchaser, lessee or encumbrancer dealing with such property in good faith for value; provided, however, that nothing in this section shall apply to the interchange of equipment in the regular course of transportation between connecting common carriers.

PRELIMINARY STATEMENT

This case is entirely about factual findings pertinent only to petitioner, validly made by the CPUC exercising its authority under state law, and presents no significant legal question that warrants this Court's review.[3]

[3] Many of the factual findings at issue were initially made by the CPUC in decisions in 1964 and 1967. App. 42 and 48.

Petitioner misrepresents the facts of its case and also fails to advise this Court that the challenged decision was modified by two subsequent CPUC decisions. App. 1 and 12. Although petitioner claims an unconstitutional deprivation of use of private property without just compensation through the U.S. Const. amend. XIV, in essence this case is nothing more than a matter of routine statutory construction of a well-established state regulatory law, the type which state appellate courts routinely resolve. Petitioner is plagued by its excess of bad judgment in 1994 and does not present this Court with a case of national importance. Nor are there conflicting decisions at issue. Petitioner's entire claim is based on the CPUC's application of Cal. Pub. Util. Code § 851, a statute first enacted by the California Legislature in 1911, to petitioner's specific facts.[4] Petitioner's constitutional argument cannot survive independently of its section 851 argument, and is entirely specific to petitioner's unique situation. Moreover, petitioner's argument ignores the plain language of section 851, which authorizes the CPUC, not petitioner, to determine whether property already dedicated to public use continues to be necessary and useful to a utility subject to its jurisdiction.

The CPUC, relying on the plain text of the unambiguous statutory provision at issue and properly adhering to generations of case law on the subject, correctly determined that petitioner was required to secure CPUC authorization to transfer any portion of its right to use

---

[4] Former section 51 of the Public Utilities Act was amended, repealed and replaced by section 851 in 1951. All statutory references hereinafter are to the Cal. Pub. Util. Code unless otherwise indicated.

water from the American River. This is because since its creation more than 150 years ago, the water right has been imbued with public utility status; in 1967 the CPUC clarified that petitioner's right remained necessary and useful. Under section 851 the right remains public utility property regardless of whether the utility uses all or a portion of it. The CPUC's construction is the only reasonable interpretation that comports with the entirety of the statute, whose purpose is to ensure that the CPUC safeguard and protect the interests of California's public utility ratepayers and ensure that the transfer of property dedicated to public service is not adverse to the public.

Petitioner's construction of the statute ignores the plain words of section 851. It would have California public utilities transferring dedicated and useful utility property without CPUC authorization if the utility determines it might not in the future use the entirety of the property at issue. Such an outcome thwarts the purpose of the statute. Moreover, in practice, petitioner's construction of the statute would have an enormously adverse impact on California consumers and ratepayers.

The challenged decisions at issue, as well as the California Supreme Court's summary denial of petitioner's writ of review of those decisions, are in keeping with established state procedure and raise no significant issues

which invoke this Court's jurisdiction.[5] Further review is not warranted.

STATEMENT OF THE CASE

1. Background. The water right at issue was initially granted to Natoma Water Company (Natoma), "based on a filing in the records of the County of El Dorado, State of California, in 1851, subsequent diversion and usage in whole or in part continuously since that time, and by application and devotion of said rights and said water to beneficial use . . . ." June 1951 Contract for Relocation, Rearrangement or Alteration of Facilities (hereinafter referred to as "1951 Contract") at 1. The Natomas Water Company (Natomas), a public utility and the successor of Natoma, and the United States Government were parties to the 1951 contract which conveyed to Natomas the right to divert no more than 60 cubic feet per second of water from the South Fork of the American River, with the proviso that the total amount of water to be diverted within any one calendar year not exceed 32,000 acre feet (AFY). 1951 Contract at 4, art. 5. Water diverted under this right was originally used by Natoma in mining

[5] "In reviewing [CPUC] decisions pertaining solely to water corporations, the review shall not be extended further than to determine whether the [CPUC] has regularly pursued its authority, including a determination whether the order or decision under review violates any right of the petitioner under the Constitution of the United States or this state." Section 1757.1(b). "[C]PUC's interpretation of the Public Utilit[ies] Code 'should not be disturbed unless it fails to bear a reasonable relation to statutory purposes and language' [citation omitted]." *Southern Cal. Edison Co. v. Peevey*, 31 Cal. 4th 781, 796 (2003).

operations and later by Natoma and Natomas for irrigation purposes.

2. Petitioner's acquisition of the public utility property. In 1964 the CPUC issued *In re Natomas Water Co. and Southern Cal. Water Co.*, Cal. Pub. Util. Comm'n Decision No. 67299, slip op. (June 3, 1964) (hereinafter "D.67299"), approving petitioner's purchase of Natomas.[6] App. 48. The purchase included the right to divert no more than 60 cubic feet per second of water from the South Fork of the American River for use in the provision of water service. D.67299 found that petitioner "proposes to render water service to the public in the territory served by Natomas, through the property being sold . . . ." App. 50, 52; *and see* Agreement for the Sale of Assets of Natomas Water Company.

3. Petitioner's first transfer of a portion of the property. In 1967 petitioner filed an application with the CPUC for authority to transfer a portion of its water right to the City of Folsom (hereinafter City). App. 42. The CPUC approved an agreement between the City and petitioner in *In Re Southern Cal. Water Co. and City of Folsom*, Cal. Pub. Util. Comm'n Decision No. 71889, slip op. (January 24, 1967) (hereinafter "D.71889"), which permitted petitioner to transfer to the City the perpetual right to the exclusive use of eleven-sixteenths of the water right purchased from Natomas in 1964. App. 44-45. In approving the transfer of the eleven-sixteenths share of petitioner's right to the flow from the South Fork of the American River, the CPUC relieved petitioner of its public utility obligation with respect to that portion of its water

[6] Petitioner is a water utility subject to the CPUC's jurisdiction.

right, but not to its remaining five-sixteenths share. App. 44-45; *see also* App. 38.

4. Petitioner's second transfer of a portion of the remaining property. In March 2004, by D.04-03-039 as modified, the CPUC found that: 1) the entire right to divert flow at a rate of up to 60 cubic feet per second from the American River constituted about 32,000 AFY of water and was included in petitioner's 1964 purchase of Natomas as dedicated public utility property; 2) a portion equivalent to about 22,000 AFY of the water right was properly transferred to the City in 1967 pursuant to D.71889; 3) the remaining five-sixteenths share of the right, about 10,000 AFY, continued to be petitioner's utility property; 4) the entire cost of the Natomas purchase was borne by petitioner's ratepayers, including the water right; 5) in 1994, petitioner entered into a contract, unbeknownst to the CPUC, with the City whereby it permanently leased half (i.e., about 5,000 AFY) of its remaining five-sixteenths share of the water right;[7] 6) petitioner recorded all of the revenues from that transfer in a non-operating below-the-line account that benefits only shareholders; 7) the water right transferred to the City by the 1994 agreement was "'useful' as that term is used in § 851, because it enhances [petitioner's] ability to meet future water supply contingencies;" and 8) petitioner prevented the CPUC from assessing whether the transfer of the water right could undermine petitioner's ability to respond to water supply contingencies thereby adversely impacting ratepayers and from assessing the effect of the below-the-line treatment of

[7] *See* Agreement for Reallocation of Water under Co-Tenancy Agreement. Petitioner "did not seek [CPUC] approval under Public Utilities Code § 851 for the 1994 lease with the City." App. 2.

lease revenues, as well as from considering any environmental impacts associated with the transfer and whether any mitigations were needed. Pet. App. 115a-116a, 122a-124a; App. 37-45. Further, D.04-03-039 also concluded that the water right was "an essential element" of petitioner's water utility company that constituted a property right that can be enjoyed even if not immediately exercised, and that the entire amount of water conferred by the right acquired in 1964 constituted utility property, as did the remaining portion following the conveyance of eleven-sixteenths to the City in 1967. Pet. App. 123a. D.04-03-039 determines that in failing to obtain CPUC authorization for the transfer of a portion of petitioner's remaining five-sixteenths share of the right, petitioner violated section 851 because the entire remaining share was useful in the performance of its duties to the public. Pet. App. 124a.

D.04-09-028 recounts the use of the water right by petitioner and its predecessors, finding that from 1966 to 1970 petitioner used approximately 500 AFY of the water right to serve irrigation customers, that petitioner constructed a treatment plant in 1973 that was capable of treating and distributing at least 5,000 AFY of the American River water entitlement, and that petitioner's use of its right fluctuated from about 678 AFY in 1973 to about 3,451 AFY in 1990. App. 14-15. D.04-09-028 finds: "At no point between the time [petitioner] purchased Natomas and the time it entered into the lease agreement with the City did [petitioner] declare that a portion of its water rights was private property. At no time did it use any of that water for its own private purposes." App. 30. In 1994 petitioner implemented a water supply policy concentrating on groundwater rather than surface water since groundwater was then less expensive; however, also in 1994 petitioner began discovering contamination in some

of its groundwater wells. App. 15-16. By 1997 increasing water contamination was apparent. In 1998, further pollutants began appearing in some of its groundwater supply, leading to the loss of 11 of petitioner's 21 wells. App. 16. To compensate for the loss, petitioner entered into a take-or-pay contract for delivery of non-potable water from the American River and the construction by petitioner of new facilities to treat that water for human consumption, all at a cost to its ratepayers.[8]

In April 2004, by D.04-04-046, the CPUC modified D.04-03-039, finding that section 851 protects the City's acquired interest in the water right on a prospective basis since it is a good faith purchaser for value, and required petitioner to file a section 851 application. App. 10. Petitioner timely applied for rehearing of D.04-03-039, as modified by D.04-04-069, making some of the arguments it raises in its petition to this Court, and in September 2004 the CPUC issued D.04-09-028, modifying D.04-03-039, as modified by D.04-04-069, and denying rehearing of the challenged decision.[9]

Following the issuance of D.04-09-028, petitioner filed a petition for writ of review of D.04-03-039, as modified by D.04-04-069 and D.04-09-028, with the California Supreme Court, arguing that "[t]his case turns on the meaning of the term 'useful' in [s]ection 851 of the California Public Utilities Code." The California Supreme Court summarily denied the petition on February 16, 2005. Pet. App. 132a.

---

[8] App. 16.

[9] App. 28-32.

REASONS FOR DENYING THE PETITION

Petitioner presents no good reasons warranting review by this Court. Petitioner's claim that the challenged decision, as modified, is wrong as a matter of law, logic and policy is hyperbole not borne out by the plain language of section 851 and simple facts in the evidentiary record that overwhelmingly support the CPUC's findings and conclusions.[10] Petitioner's claim that its water right was never dedicated to public use is refuted by every fact in the underlying proceeding and contradicted by petitioner's own recitation of the facts in its petition before this Court. Aside from attempting to rewrite over 150 years of history, petitioner is not only asking this Court to review the record below de novo and substitute its judgment for the CPUC's findings of fact and conclusions of law but is using its petition to impermissibly challenge D.71889 and D.67299, well beyond the 30-day statutory period for applying for rehearing of CPUC decisions.[11]

There is no merit to petitioner's argument. Unlike in the cases upon which petitioner relies, the water right at

---

[10] Petitioner has failed to show that the challenged decisions are not supported by substantial evidence. Section 1757.1; *City of San Francisco v. Public Utilities Comm'n*, 39 Cal. 3d 523, 530 (1985); *Southern Cal. Gas Co. v. Public Utilities Comm'n*, 23 Cal. 3d 470, 480 (1979); *Yucaipa Water Co. No. 1 v. Public Utilities Comm'n*, 54 Cal. 2d 823, 828 (1960). In *City of S.F.*, *supra* 39 Cal. 3d at 530, the court stated: "[T]he [CPUC's] findings are ordinarily conclusive and not subject to review." Further, if they are supported by any evidence, such findings may not be set aside. *Id.* citing *Yucaipa Water Co. No. 1*, *supra* 54 Cal. 2d at 828.

[11] Pursuant to section 1756 an application for rehearing challenging the lawfulness of a [CPUC] decision must be filed within 30 days from the date the decision is mailed. *See also*, CPUC Rules of Practice and Procedure, rule 85.

issue was suffused with a beneficial use and used to serve public utility customers when petitioner purchased it, has continuously been used to serve the public, retained its public use status after the CPUC authorized petitioner, pursuant to section 851, to transfer a portion of it to a municipal utility in 1967, and remains to this day, necessary and useful to petitioner's public utility service.

In 1967 petitioner complied with the section 851 requirement that it obtain CPUC approval prior to any transfer of a portion of the water right. App. 44-46. As petitioner readily acknowledges, nothing substantial changed regarding the property between 1964 when petitioner purchased it and 1994 when it transferred another portion of its right without proper CPUC authorization. App. 27. In 1967, the CPUC found that the portion transferred to the City was no longer necessary and useful to petitioner's water utility business. App. 45. Petitioner did not ask and the CPUC did not find that the remaining five-sixteenths portion was no longer necessary and useful to its public utility service. Petitioner has failed to explain why it did not pursue its current argument in 1967, when it first sought authority under section 851 to transfer a portion of its right to the City. If petitioner was so certain that the facts establish that a portion of its right was not subject to section 851, it should have brought the issue to the CPUC's attention then. App. 27-28. Petitioner has an obligation under California law to come before the CPUC prior to leasing away its water rights and it failed to do so.[12] Petitioner's unilateral conclusion that it did not need authorization in 1994 to transfer a portion of property

[12] Cal. Const. art. XII § 3; Pub. Util. Code §§ 216, 702, 851, 2106, 2107; CPUC's Rules of Practice and Procedure, rule 1.

already dedicated to public use disregards the California Constitution and Public Utilities Code, as well as relevant federal and California case law.

1. THERE IS NO TAKING BECAUSE THE WATER RIGHT HAS ALWAYS BEEN DEDICATED TO THE PUBLIC BENEFIT AND USEFUL TO THE PETITIONER AND ITS PREDECESSORS IN SERVING THE PUBLIC.

Petitioner bases its takings argument on certain undisputed facts settled by the evidentiary record which supports D.04-03-039, as modified by D.04-04-069 and D.04-09-028: Petitioner, like its predecessors, has continuously used water from this right to serve its customers; also like its predecessors, it has never used the entire amount of water the right entitles it to use.[13] App. 29-30. Petitioner made the same argument to the CPUC and the California Supreme Court that it now makes to this Court, and D.04-09-028 addresses it:

> As with its other arguments, [petitioner's] entire takings argument rests on the position that the

[13] Although definitive numerical values (e.g., 10,000 AFY) have been used to describe the right, in reality the exact figure equaling the volume of the total annual water the right entitles petitioner and its predecessors in interest to divert is really an estimate of the maximum amount of water petitioner has a right to apportion from the river, conditions permitting. On any given day, the actual amount of water that is the subject of the type of water right in question is largely determined by natural forces. *People v. Murrison*, 101 Cal. App. 4th 349, 359 (2002), *review denied*, 2002 Cal. LEXIS 7988 (Nov. 20, 2002); *United States v. State Water Resources Control Bd.*, 183 Cal. App. 3d 82, 104 (1986). The right at issue is to divert up to a particular volume of water flow.

> water rights in question are private, as opposed to utility, property. [Petitioner] spends six pages of its application for rehearing presenting an analysis of takings law as it applies to private water rights. While this discussion is interesting, it simply does not apply if the water rights in question are not private property.
>
> *The takings argument fails from two standpoints. First . . . [petitioner's] argument that the leased water rights are private property lacks merit; therefore, there is no taking – property that is useful to the business of providing water to the public cannot be taken by our lawful exercise of our jurisdiction under section 851. Second . . . we have determined that the lease is valid as to Folsom and have ordered [petitioner] to file a section 851 application (which it has done) for authorization of the lease. This is exactly what [petitioner] has, since 1994, wanted to do with the 5,000 AFY of water . . . . Hence, even if there were a shred of merit to [petitioner's] argument about private property, nothing about our actions at this point . . . amounts to a taking of any property of [petitioner].*

App. 30-31, emphasis added. Petitioner's assertion that its water right was never dedicated to public use is disingenuous and completely contradicted by the facts. The water right was public utility property dedicated to and used by the public since the days of Natoma. Petitioner purchased it as such from Natomas and continued to use it as such following D.67299. Even if the water right had not been dedicated to public use when petitioner purchased it (although it clearly was), D.71889 found that it was dedicated property and further found that eleven-sixteenths of the total right was no longer necessary and

useful and permitted petitioner to sell that portion to the City. The remaining five-sixteenths remained necessary and useful, regardless of whether it was potable water or whether petitioner chose to use all or a portion of it.

Petitioner has cited no cases that support its argument that it holds the power to determine that dedicated property used in public service is no longer necessary and useful if not all of it is being used. The argument is equivalent to asserting petitioner is empowered to declare that its groundwater wells and/or the waters in them are not dedicated to public service if petitioner is not using one hundred percent of the water in those wells. The proposition is wrong as a matter of settled utility law.

2. PETITIONER'S DEDICATION ARGUMENT IS BASED ON ARBITRARY ASSUMPTIONS AND A COMPLETE DISREGARD OF THE FACTS.

Petitioner's argument that it dedicated 5,000 AFY but not the full 10,000 AFY equivalent of its five-sixteenths remaining water right to public use cannot survive petitioner's logic. Petitioner asserts that it has never used more than 3,500 AFY of its entitlement, yet simultaneously argues that 5,000 AFY of its remaining entitlement is dedicated. Petitioner cannot justify the difference between the 1,500 AFY it claims is dedicated but never used and the other 5,000 AFY equivalent of its remaining five-sixteenths right that it claims is not dedicated because petitioner had not made use of it. Thirty-eight years ago, the CPUC found the five-sixteenths share of the water right at issue here to be public utility property for all of the reasons already discussed above and set forth in the challenged decisions.

The facts of D.04-03-039, as modified, are entirely distinguishable from those giving rise to *Richfield Oil Corp. v. Public Utilities Comm'n*, 54 Cal.2d 419 (1960), *cert. denied sub nom. Southern Counties Gas Co. v. Public Utilities Comm'n*, 364 U.S. 900 (1960), and the line of cases cited by petitioner, all of which concern whether a non-public utility entity or non-dedicated property has attained, by virtue of its use, public utility status. Petitioner disregards the plain language of section 851 and confuses the necessity and usefulness of its entitlement to its right with its decision not to use all of the water it is entitled to divert. In what may be considered the ultimate irony, the usefulness of the right was manifested almost immediately in the contamination of petitioner's wells, following petitioner's unilateral transfer to the City. Because petitioner was no longer able to make full use of its entitlement, it became absolutely necessary that it seek alternate supplies of water from other, more expensive sources, to the detriment of its customers.

CONCLUSION

The issues presented by petitioner are entirely fact dependent and affect only petitioner. Although petitioner argues an unconstitutional taking, in reality, petitioner is challenging the CPUC's proper exercise of its jurisdiction to apply a long-standing state law to petitioner's unique facts. The CPUC considered all of the arguments petitioner has raised to this Court and correctly decided the issues. Petitioner exercised bad judgment in 1994, and its argument is without merit. This is not a case of national importance and there are no conflicting decisions at issue. This case is not worthy of this Court's attention.

The petition for a writ of certiorari should be denied.

Respectfully submitted,

RANDOLPH L. WU
ANNE K. MESTER
ELEANOR M.W. YOUNGSMITH*
**Counsel of Record*
505 Van Ness Avenue
San Francisco, CA 94102
Telephone: (415) 703-2088

Attorneys for the Public Utilities Commission of the State of California

June 17, 2005

Mailed April 27, 2004

Decision **04-04-069 April 22, 2004**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SOUTHERN CALIFORNIA WATER COMPANY (U 133-W), for an order authorizing it to increase rates for water service by $19,826,100 or 29.72% in the year 2003; by $6,327,800 or 7.31% in the year 2004; and by $6,326,200 or 6.81% in the year 2005 in its Region III Service Area and to increase rates for the General Office Allocation in all of its Customer Service Areas in this Application including: Arden-Cordova, Bay Point, Clearlake, Los Osos, Ojai, Santa Maria, Simi Valley and Metropolitan.	Application 02-11-007 (Filed November 4, 2002)

OPINION GRANTING PETITION TO MODIFY D.04-03-039

I. Summary

On March 16, 2004, the Commission adopted Decision (D.) 04-03-039, which grants Southern California Water Company (SCWC) authority to increase rates in its Region III Service Area. The Commission found that SCWC violated Public Utilities Code Section 851 (§ 851) when it failed to seek the Commission's approval for its lease of water rights to the City of Folsom (City). Additionally, the

Commission held that the City's retrospective use of the water rights was unaffected by the voided lease agreement. The Commission deferred to a subsequent decision, following briefing by the parties, the issue of Folsom's prospective rights under the voided lease. The City seeks relief, as it believes that serious and immediate effects have occurred because the Commission did not preserve its prospective rights under the lease. As such, the City has filed a petition to modify D. 04-03-039's treatment of prospective water rights leased from SCWC. After a review of the new information provided to the City, we conclude that § 851 protects the City's acquired interest in the water both with respect to the past and to the future notwithstanding our voiding of the lease as to SCWC.

II. Background

By D.71889 issued January 24, 1967, the Commission authorized SCWC to transfer the City water system and 22,000 acre feet per year (AFY) to the City of Folsom. In November 1994 SCWC signed an agreement to lease in perpetuity an additional 5,000 AFY to the City. SCWC did not seek Commission approval under Public Utilities Code § 851 for the 1994 lease with the City. As a result, the Commission determined that SCWC violated § 851 by not seeking approval for a water rights lease agreement that it entered into with the City (D.04-03-039). Accordingly, the Commission fined SCWC a net total of $180,000 ($1,095,000 with $915,000 suspended) for that violation. Moreover, the Commission determined that while the City acted in "good faith for value", the City was entitled only to retrospective protection of its lease of water rights, pending further record development in the issue of Folsom 's prospective rights under the voided lease.

III. Discussion

This petition to modify narrowly focuses on the issue of prospective water rights leased by the City in an agreement with SCWC in 1994. The Commission found in D.04-03-039 that SCWC had violated § 851 by failing to seek Commission approval to lease 5,000 AFY to the City in perpetuity. The City alleges that by not protecting its future rights under the lease, the Commission has caused immediate and severe harm. Specifically, by placing a cloud over the City's right to the leased water, the Commission has made it difficult or impossible for the City to refinance on unfavorable terms over $100 million of existing utility bonds; has placed the City in potential default under existing bond indentures; jeopardized planned expansion in the City's East Area particularly including the planned development of a desperately needed hospital and urgent care facility; and generally rendered doubtful various developments contained in the City's master plan for the East Area all of which assume the continuing availability of the leased water.

To address these concerns we revisit the plain words of the relevant statute. The relevant part of § 851 reads:

> . . . any disposition of property by a public utility shall be conclusively presumed to be of property which is not useful or necessary in the performance of its duties to the public, as to any purchaser, lessee or encumbrancer dealing with such property in good faith for value : . .

D.04-03-039 (page 53) concludes that the City is a good faith purchaser for value and therefore entitled to protection of its water rights on a retrospective basis. The City argues that the Commission, by not also granting a

prospective approval of the leased water rights, is misinterpreting the language and intent of the statute.

The Commission, however, must reconcile the City's needs with its obligation to enforce § 851 in order to determine whether the transaction (in this case, the agreement between the City and SCWC for leased water) serves the public interest. To this end, D.04-03-039 notes that there are several factors that the Commission must consider before granting § 851 approval. For example, the Commission must assess whether the proposed transaction will impair the utility's ability to provide service to the public. As such, SCWC must demonstrate that its water quality and supply problems can be addressed without the leased water supply (see Decision at page 44).

In D.04-03-039 it was concluded that SCWC violated § 851 when it failed to gain the Commission's approval prior to entering into an agreement with the City for leased water rights. As part of the remedy outlined in D.04-03-039, the Commission voids the lease as to SCWC, and fines SCWC the net sum of $180,000.

In its petition to modify D.04-03-039, the City of Folsom has presented new evidence that heretofore has not been considered by the Commission. Ten years after the execution of the leased water rights agreement with SCWC, on March 16, 2004, the City first learned that the Commission had issued a decision voiding the leased water agreement. On March 26, 2004, the City filed a petition to modify D.04-03-039. Upon further review of the City's petition, we conclude that § 851 protects the City's acquired interest in the water both with respect to the past and to the future notwithstanding our voiding of the lease as to SCWC. Accordingly, within 30 days from the

issuance of this opinion, we direct SCWC to file a § 851 application for the leased water rights agreement with the City. This requirement provides clarity to SCWC that it is expected to file a § 851 application.

In view of this revision to our original decision, we also revise our order. We direct that the parties in that application proceeding address the following topics:

1. How SCWC will obtain water sufficient to serve its customer base without the 5,000 AFY leased to the City.

2. The proper accounting and ratemaking treatment of future lease revenues under the City lease.

3. Any appropriate measures to ensure ratepayers are not adversely affected by the lease of water rights to Folsom.

IV. Comments on the Proposed Draft Decision

On March 26, 2004, a "Proposed Draft Decision of President Peevey and Commissioner Kennedy", which addressed Folsom's petition for modification was issued. Comments were due on March 30, 2004. Comments were timely filed by Southern California Water Company, City of Folsom and the Office of Ratepayer Advocates. By way of summary, Folsom supported the draft decision with minor changes. Their comments were considered and changes to the draft decision were not deemed necessary. The SCWC supported the draft decision but sought clarification as to whether or not they had to file a brief addressing the rights of Folsom under three different circumstances. The draft decision provided clarity and required that SCWC file a § 851 decision within 30 days of

the decision. ORA challenged the draft decision's conclusion that Folsom is a "bona fide purchaser" and entered into the leased water rights agreement with SCWC in good faith for value. ORA argued that an appropriate reading of § 851 would lead one to conclude that the water rights still are useful to SCWC and that prospective use of the leased water could not be granted until the Commission determines that the property is not useful to SCWC. We disagree.

The Commission does not have the power under § 851 to declare Folsom's entitlement to the water rights void; it has only the power to declare the lease of those rights void. The second paragraph of § 851, in our opinion, recognizes that a good faith purchaser for value from an owner with good title, like the water company, is going to acquire good title from his seller.

On March 26, 2004, an Alternate Draft Decision of Commissioner Lynch was issued for comment. The voiding of the lease pursuant to Ordering Paragraph 7 of D.04-03-039 was stayed in order to clarify Folsom's continuing right to use water under the lease. The alternate draft decision was adopted at the April 1, 2004 Commission Meeting. There was no action taken on the Peevey and Kennedy draft decision. Accordingly, an Assigned Commissioner's Ruling was issued on April 2, 2004 that bifurcated the issue of Folsom's prospective use of the leased water from the Commission's consideration of SCWC's § 851 application. Also, an oral argument on April 19, 2004 was granted to allow parties further opportunity to comment on the prospective use of leased water by Folsom. Due to the very short comment period for the March 26, 2004 draft decision, additional comments were taken.

The re-circulated draft decision of President Peevey and Commissioner Kennedy in this matter was mailed to the parties in accordance with Public Utilities Code Section 311(g)(1) and Rule 77.7 of the Rules and Practice and Procedure. Comments were due on April 14, 2004, and an oral argument was held on April 19, 2004. Comments were timely filed by Southern California Water Company, City of Folsom and the Office of Ratepayer Advocates. SCWC argues that § 851 provides that a disposition of property by a public utility shall be conclusively presumed to be property, which is not useful or necessary of its duties to the public, as to any purchaser, lessee or encumbrancer dealing with such property in good faith for value. SCWC suggests that past Commission decisions and California case law would provide Folsom with a favorable reading of its prospective right to the leased water.

Folsom again supports the Peevey and Kennedy draft decision and in doing so provides an extensive legal analysis of the legislative intent of § 851, past Commission decisions, and California case law. In sum, Folsom argues that the plain language of § 851 conclusively establishes the rights of good faith purchasers for value in their acquired property. Folsom adds that the legislature clearly intended to protect purchasers dealing with such property in good faith for value. In short, Folsom concludes that the Commission is statutorily precluded from voiding the property rights of a good faith purchaser for value. We agree.

ORA, after having more time to reflect and analyze the legal implications of granting Folsom's prospective use of the leased water rights, reverses its earlier course and acknowledges that Folsom has a continuing right to the leased water, assuming it is a good faith purchaser. ORA

now recognizes that underlying Commission decisions and a Supreme Court opinion supports Folsom's argument that it as a good faith purchaser is prospectively entitled to the leased water. Nonetheless, ORA is not convinced that Folsom has conclusively demonstrated that it is a bona fide purchaser to the leased water, although no party (including ORA) asserts otherwise, and would require that this issue be disposed of in SCWC's § 851 application. To our knowledge, no party has provided evidence that Folsom is not a bona fide purchaser; in fact Folsom has submitted two declarations by its City attorney that it indeed is a bona fide purchaser, and, further argued that the Commission has already disposed of this factual issue in D. 04-03-039, by finding Folsom properly used the water rights since the inception of the sale transaction.

On April 16, 2004, Folsom submitted a Motion to Strike Section II of ORA's supplemental comments. We will not strike ORA's comments as we believe that ORA is entitled to provide analysis and conclusion on the issue of Folsom's water rights. However, we decline to devote further hearing or deliberative efforts on this issue. Additionally, Folsom filed a supplemental declaration of Mr. Steven P. Randolph on April 16, 2004 in support of Folsom's petition for modification. This filing is similar to the declaration that Mr. Randolph executed on March 25, 2004.

V. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and David Fukutome is the assigned ALJ in this proceeding.

Findings of Fact

1. In D.04-03-039, the Commission found that SCWC violated § 851 by not seeking the Commission's approval for its lease of water rights to the City.

2. As part of the remedy outlined in D.04-03-039, the Commission voided the lease as to SCWC, and fined SCWC the net sum of $180,000.

3. In D.04-03-039, the Commission safeguarded the City's retrospective rights under the voided lease agreement and reserved decision on the City's prospective right pending further record development.

4. As a result, the City has filed a petition to modify D.04-03-039 because of the serious and immediate effects that occurred because the Commission did not protect its prospective rights under the lease.

5. The City may have to refinance on unfavorable terms over $100 million of existing utility bonds.

6. The City may be in jeopardy in being able to finance planned expansions of the City's East Area.

Conclusions of Law

1. The City has demonstrated that there are severe and immediate impacts to its water supply and financial health because the Commission did not grant prospective approval of its leased water rights.

2. Pursuant to Government Code Section 11125.3 (a)(2), there exists a need to take immediate action in that the City of Folsom's water supply may be severely curtailed and its financial condition negatively impacted if

the Commission does not review its D.04-03-039 adopted March 16, 2004; this need for action came to the Commission's attention subsequent to the mailing of its April 1, 2004 agenda.

3. The Commission in D.04-03-039 concludes that the City is a good faith purchaser for value in compliance with § 851.

4. In this instant case, the Commission must reconcile the City's needs for the leased water rights to its obligation to enforce § 851 by determining whether or not the agreement between the City and SCWC for leased water serves the public interest.

5. After a review of new information, the Commission concludes that § 851 protects the City's acquired interest in the water both with respect to the past and to the future notwithstanding the voiding of the lease as to SCWC.

ORDER

IT IS ORDERED that:

1. Within 30 days from the issuance of this opinion Southern California Water Company is to file a § 851 application for the leased water rights agreement with the City of Folsom.

2. We direct that the parties in that application proceeding address the following topics:

a. How SCWC will obtain water sufficient to serve its customer base without the 5,000 AFY leased to the City.

b. The proper accounting and ratemaking treatment of future lease revenues under the City lease.

c. Any appropriate measures to ensure ratepayers are not adversely affected by the lease of water rights to Folsom.

Dated April 22, 2004, at San Francisco, California.

MICHAEL R. PEEVEY
President

CARL W. WOOD
LORETTA M. LYNCH
GEOFFREY F. BROWN
SUSAN P. KENNEDY
Commissioners

I reserve the right to file a concurrence.

/s/ LORETTA M. LYNCH
Commissioner

I reserve the right to file a concurrence.

/s/ SUSAN P. KENNEDY
Commissioner

I reserve the right to join Comr. Kennedy's concurrence.

/s/ GEOFFREY F. BROWN
Commissioner

MAIL DATE
September 9, 2004

Decision 04-09-028 September 2, 2004

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

In the Matter of the Application of SOUTHERN CALIFORNIA WATER COMPANY (U133-W), for an order authorizing it to increase rates for water service by $19,826,100 or 29.72% in the year 2003; by $6,327,800 or 7.31% in the year 2004; and by $6,326,200 or 6.81% in the year 2005 in its Region III Service Area and to increase rates for the General Office Allocation in all of its Customer Service Areas in this Application including: Arden-Cordova, Bayu Point, Clearlake, Los Osos, Ojai, Santa Maria, Simi Valley and Metropolitan.	Application 02-11-007 (Filed November 4, 2002)

ORDER MODIFYING AND DENYING REHEARING OF DECISION 04-03-039

Decision (D.) 04-03-039 (the Decision), challenged in this case by the Southern California Water Company (SCWC), granted in part SCWCs application to increase rates for years 2003-2005 in its Region III Service Area. The Decision also held that SCWC violated Public Utilities

Code section 851[1] when in November 1994, without seeking Commission approval, SCWC entered into a lease agreement with the City of Folsom (City or Folsom) allowing the City in perpetuity to lease 5,000 acre-feet per year (AFY) of water rights from SCWC's 10,000 AFY allocation of water from the American River. SCWC had been booking the revenues from this lease in a non-operating revenue account. The Decision concluded that this lease is void, imposed a fine on SCWC, and ordered 70% of the revenues received under the lease to be credited to SCWC's ratepayers. In addition, the Decision held that the City's retrospective use of the water rights was unaffected by the voided lease agreement.

SCWC filed a timely application for rehearing, in which it challenges the Decision's application of section 851, the imposition of the fine, and the revenue credit to ratepayers, including the interest rate applied. The Commission's Office of Ratepayer Advocates (ORA) filed a response in opposition.

We have reviewed SCWC's 53-page application, much of which has been argued in the course of this case, and are of the opinion that no grounds for granting rehearing have been stated. With the possible exception of its challenge to the interest rate, all of SCWC's arguments rely on its fundamental claim that the water rights it leased to the City in perpetuity are private property that was not useful to the provision of public utility service in 1994. Because the record and relevant legal authority provide a basis for our finding to the contrary, we find that none of

---

[1] All statutory citations are to the Public Utilities Code unless otherwise stated.

SCWC's arguments relative to section 851, including its constitutional claims, have merit. Its challenges to the fine and reallocation of past lease revenues likewise fail. We do modify the Decision to further clarify our rationale for both the reallocation and the interest rate we apply. The remainder of D.04-03-039, as modified by D.04-04-069[2], remains the same.

We preface our analysis by setting forth in more detail the background of this case.

BACKGROUND

In June 1964, SCWC purchased the Natomas Water Company. With the purchase, as is clearly spelled out in the contract governing the purchase (Ex. 56; see also ORA Opening Brief (O.B.), p. 35), SCWC obtained 32,000 AFY of water rights to the American River.[3] Subsequently, in January 1967, the Commission in D.71889 authorized SCWC to transfer its Folsom water system and 22,000

---

[2] D.04-04-069 is discussed below.

[3] Section 1.01 of the contract, titled "The Property Identified," states:

> "The "Property" herein referred to is all the properties, whether real, personal or mixed, tangible or intangible, used by or useful to Seller in connection with the performance of its duties to the public. The property includes, by way of illustration and not as an enumeration:
>
> "d) Water Rights. All water and water rights both surface and subsurface (including inchoate rights and undivided interests and rights), owned or claimed by Seller on the Closing Date including without limiting the generality of the foregoing all rights involved in or created by the Contract for Relocation, Rearrangement or Alteration of Facilities (the 'Contract') attached hereto as Schedule C." Ex. 56.

AFY of its American River water rights to the City of Folsom.

From 1966 to 1970, SCWC used approximately 500 AFY of raw, untreated water from the American River to serve irrigation customers in Rancho Cordova. At that time, SCWC had no facility to treat surface water, since with the transfer of the Folsom water system, the City had acquired the Folsom Treatment Plant.

SCWC constructed the Coloma Treatment Plant, which became operational in 1973, to treat surface water. The plant and system that was recorded in SCWC's rate base could treat and distribute, according to SCWC, only 5,000 AFY of SCWC's American River water entitlement. The record in this case contains a chart showing that SCWC's use of surface water ranged from a low of 678 AFY in 1973 to 3,451 AFY by 1990. (Ex. 38, ex. B.)

By 1994, SCWC had begun implementing a water supply policy that concentrated on groundwater rather than surface water for supplying its public utility customers. Among other reasons, groundwater was cheaper, since the cost to produce and deliver it did not include the labor cost of operating the Coloma plant, as was the case with surface water. In November of 1994, SCWC entered into the agreement with Folsom to lease to the City in perpetuity 5,000 AFY of its remaining 10,000 AFY entitlement of American River water. At that time, SCWC had not been taking more than 3,451 AFY of that entitlement. SCWC did not come to the Commission for authorization under section 851 before entering into the agreement with Folsom. SCWC did provide Folsom with a letter from counsel in which counsel stated that other than the consent the U.S. Bureau of Reclamation had given, SCWC

needed no governmental permits or approvals to proceed with the lease agreement. (See Declaration of Steven P. Rudolph in Support of City of Folsom's Petition to Modify and Motion to Partially Stay Decision 04-03-039, Ex. D, p. 4, para. 7.) SCWC booked lease revenues in PUC Account 526, Miscellaneous Non-Operating Revenues, which is a below-the-line account solely benefiting shareholders.

Also in the 1994 timeframe, SCWC began experiencing problems with contamination in some of its groundwater wells. According to SCWC, at that time the only contamination believed to be a problem was from trichloroethylene (TCE), which could be removed by installing granulated activated carbon filters on the wells. However, in the 1997 timeframe, per chlorate contamination became apparent; in 1998, NDMA appeared on the scene. Neither of those chemicals is able to be removed like TCE is, and SCWC has had to take 11 out of 21 wells out of service. To assure the necessary continued water supply, the company has placed into operation several new groundwater wells located away from the contamination. It has also entered into a five-year take-or-pay contract with the Sacramento Municipal Utilities District for 10,000 AFY of American River water, which SCWC says has necessitated installing new treatment capacity. Ratepayers will be footing the bill for this replacement water.

The issue of whether SCWC should have come to the Commission for prior authorization of the lease was raised when the Commission staff, in the course of reviewing documents for SCWC's test year 2001 General Rate Case (GRC) for SCWC's Region I, discovered the lease revenues in Account 526. Staff contended that SCWC had violated section 851, which SCWC rebutted. The Region I GRC was settled, and the settlement agreement deferred the lease

issue to SCWC's GRC for Region II, expected to be filed in early 2001. That GRC was not filed; thus the issue has been raised in this proceeding, SCWC's GRC for Region III, filed November 4, 2002.

The Decision, issued March 16, 2004, finds that SCWC violated section 851 in failing to obtain Commission approval for the lease, voids the lease as to SCWC, and fines SCWC $1,095,000, of which $915,000 is suspended, for a net fine of $180,000. The Decision also assigns all lease proceeds from the date of the Decision forward to an operating revenue account, and directs a credit to future rates equal to 70% of lease revenues received from the inception of the lease to the effective date of D.04-03-039, plus 7% interest. The Decision holds that the City's retrospective use of the water rights is unaffected by the voided lease agreement, but defers to a subsequent decision, following briefing by the parties, the issue of Folsom's prospective rights under the voided lease.

Significant procedural developments occurred after the issuance of the Decision which have a bearing on SCWC's application for rehearing. Within days after the Decision was issued, the City filed a motion for partial stay and a petition for modification of it, claiming that serious and potentially devastating economic and financial effects would occur because we did not preserve the City's prospective rights under the lease. The City had received no notice that the issue of the validity of the water rights lease was before the Commission, and was not a party in this case. The City asked us to clarify that as to Folsom, a good faith purchaser for value under section 851, the agreement with SCWC creating the lease is not void. SCWC supported Folsom's requests.

In support of its motion for partial stay and petition for modification, the City submitted new information to the Commission on the City's financial situation, as well as legal analysis on the second paragraph of section 851, which provides in relevant part:

> "[A]ny disposition of property by a public utility shall be conclusively presumed to be of property which is not useful or necessary in the performance of its duties to the public, as to any purchaser, lessee or encumbrancer dealing with such property in good faith for value. . . ."

On April 1, in D.04-04-018, we stayed Ordering Paragraph 7 of the Decision as to the City's prospective rights, pending clarification of the City's continuing right to receive water under the lease. In other words, we stayed the voiding of the lease prospectively as to Folsom.

After reviewing Folsom's new information and analysis in detail, we concluded in D.04-04-069 (the Modification Decision), issued April 22, that since the City was a lessee acting in "good faith for value," section 851 protects its acquired interest in the water both with respect to the past and to the future, notwithstanding our voiding of the lease as to SCWC. However, we also concluded we must "reconcile the City's needs for the leased water rights to [the Commission's] obligation to enforce section 851 by determining whether or not the agreement between the City and SCWC for leased water serves the public interest." (D.04-04-069, Conclusion of Law 4, p. 9.) thus we ordered SCWC to file a section 851 application by May 27. The company did so, and that application is now under review by ALJ Fukutome, who was also the ALJ in the instant case.

Prior to issuance of the Modification Decision, SCWC filed its application for rehearing of the Decision. SCWC's voluminous application, which, of course, does not take into account the changes made in the Modification Decision, contends that: A) the Decision erroneously finds that the lease violates section 851, because the water rights leased to the City are not "used and useful" property; B) the Commission has unconstitutionally exceeded its jurisdiction because the water rights at issue are not "dedicated to a public use;" C) the Decision imposes a taking without just compensation, in violation of the California and U.S. Constitutions; D) the Decision violates Article X, section 2 of the California Constitution requiring reasonable and beneficial use of water; E) the fine of $1,095,000 (all but $180,000 of which was suspended) is unlawful; F) the allocation of 70% of the lease revenues to ratepayers is arbitrary; and G) the 7% interest rate on the ratepayer allocation of those revenues is contrary to Commission precedent.

ANALYSIS

A. SCWC's Section 851 Arguments.

SCWC begins its challenge to D.04-03-039 by arguing that the Decision unlawfully and erroneously applies section 851 to the 1994 lease. The gist of this argument is that the American River water rights held by SCWC are private water rights, having never been dedicated to public utility service; thus the Commission has no authority to regulate them and cannot apply section 851 to any transaction involving those water rights. SCWC claims that both the statute itself and Commission decisions issued prior to November 1994, when the lease was entered into, support its argument.

Section 851 provides, in relevant part:

> "No public utility . . . shall sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or any part of its . . . property necessary or useful in the performance of its duties to the public . . . without first having secured from the commission an order authorizing it so to do. Every such sale, lease, assignment, mortgage, disposition, encumbrance, merger or consolidation made other than in accordance with the order of the commission authorizing it is void. . . ."

SCWC first argues that its water rights were not necessary or useful in the performance of its duties to the public. SCWC contends that in general, the utility is the entity which makes the initial decision whether an item of property is necessary or useful, *In re Citizens Utilities Co. of California* (1988) 28 Cal. P.U.C.2d 108, 119, and at the time of the November 1994 lease, SCWC had made the decision that 5,000 AFY of its water rights were not necessary or useful. This was because as of November 1994, SCWC had never used more than 3,451 AFY of its total remaining 10,000 AFY rights for any purpose whatsoever; had never used any of its American River water to provide potable water but only irrigation water, and had been developing ground water wells to service the majority of its customers with potable water; and had never developed water treatment facilities which could treat more than 5,000 AFY.

SCWC has it backwards. In case after case, it is the Commission that determines, after a utility comes in for section 851 approval, that such approval is or is not required because the property is or is not necessary or useful to the company's public utility business. While the

Citizens case, *supra,* does state that the initial determination is for the utility to make, it also states that "[i]n any event the issue [of necessary or useful] is a factual one that the Commission may review." *Id.* SCWC's great failing is not having come before us in 1994.

SCWC cites four cases it believes support its position that since it had determined that its failure to ever use the American River water to supply potable water meant that these water rights never became necessary or useful, it did not have to come before us under section 851. None of the cases are helpful to SCWC.

SCWC relies heavily on *In re Pacific Gas & Electric Co* (1981) 10 Cal. P.U.C.2d 647. This case involved PG&E's sale of real property containing coal reserves that PG&E had originally purchased to provide fuel for a power plant which was cancelled, thus PG&E had no use for the property in question. In an investigation of the sale transaction, for which PG&E did not seek section 851 authorization, the Commission held that because the property was not necessary or useful at the time of the sale, the sale was not subject to section 851 review. SCWC claims the *PG&E* case supports its position because the water rights in question were not necessary or useful at the time it entered into the lease with Folsom. SCWC makes no effort to refute the other two reasons we gave in the Decision for why *Pacific Gas & Electric* does not help SCWC: PG&E had disposed of the entirety of its coal mine assets, and had not tried to split up an asset that was useful in serving customers; and unlike PG&E's shareholders, SCWC's shareholders have not accepted the risk of any replacement water rights that SCWC needs to acquire in order to make up for the portion leased away. (D.04-03-039, p. 51.)

SCWC further argues that in *Pacific Gas & Electric,* the Commission holds that if a utility could present evidence that the property was not used or useful, section 851 would not apply to a transaction involving that property. SCWC's primary problem here is that it never came to us with such purported evidence until it was forced to rebut ORA's challenge to the lease. Additionally, in the *PG&E* case, the property in question was never devoted to utility service; the coal reserves were going to fuel a power plant that was later cancelled. As the Commission stated in a later decision:

> "These two cases [*Pacific Gas & Electric, supra,* and *Citizens,* discussed below] illustrate the principle that property far removed from the utility's public service purpose does not fall within the ambit of Section 851."

In re Pacific Bell (1996) 65 Cal.P.U.C.2d 324, 327.

SCWC argues that is the case here too. However, the two situations are simply not comparable. Here, SCWC is a public utility water company in the business of providing water to the public. The water SCWC has provided its customers comes from two sources: surface water from its American River water rights, and ground water from wells it has developed. Its surface water rights, rather than being "far removed" from the utility's public service purpose, have been part and parcel of the utility property since the mid-1850's. See *Williamson v. Railroad Commission* (1924) 193 Cal. 22. It defies logic to think that SCWC could contemplate a lease in perpetuity of a portion of those water rights – which involve exactly the commodity it is in business to provide, and which source it has used to provide public utility customers with water – without at

least coming to us to argue it did not need our authority to do this.

SCWC also relies on *In re Citizens Utilities Co. of California, supra. Citizens* involved an investigation of a sale of timber rights some 17 years earlier, which had occurred without section 851 authorization. The Commission staff had argued that timber rights were necessary and useful because they afforded the utility protection over its water resources. The Commission disagreed, after hearing testimony that timber harvesting was being done compatible with protecting the water resources, and held that the timber rights were not necessary or useful to the provision of water to customers. SCWC argues that like the timber rights, the water rights that it leased to Folsom were not necessary or useful in the provision of water to its customers. SCWC does not address the significant distinction we make between timber rights and the water rights themselves, i.e., the very resource that the utility is responsible for providing. (See D.04-03-039, p. 52.)

SCWC's other two cases, *In re Valencia Water Co.* (1992) 47 Cal. P.U.C.2d 493, and *In re California Water Service Co.* (1994) 56 Cal. P.U.C.2d 4, are equally unhelpful to its cause. *Valencia* involved a wholly privately owned well which, when transferred by the public utility to another entity, did not lose its private character. It had never been used to provide water to the public. In *California Water Service Co.,* the property in question entailed several lots upon which the water company had once had wells, storage tanks, or booster plants which had at one time been used in public utility service. At the time of the sale, however, the property was depleted and the facilities had been removed. The Commission found the property

was no longer necessary or useful, and no section 851 review was required prior to its sale.

SCWC then criticizes two of the authorities we cite in support of our conclusion that the lease agreement required section 851 review. *In re Pacific Gas & Electric Co.* (1992) 45 Cal. P.U.C.2d 24, involved PG&E's fiber optic communications capacity. The Commission found that a portion of the property MCI wanted to use (in exchange for giving PG&E capacity on MCI's nationwide telecommunications system) was being used by PG&E to serve the public; thus the transaction was subject to section 851 review. SCWC says *Pacific Gas & Electric* is not factually applicable to its water rights situation.

While factually the cases have some differences, the fiber optic capacity in *MCI* can be viewed as analogous to the water rights situation here. The point made by the Decision is that a utility cannot decide that part of the same item of property is utility property and part is not, where part of that property is indeed being used in provision of utility service. SCWC, and Natomas Water Company before it, both made use of some part of their American River water rights to serve customers. At almost no point from the time SCWC purchased the Natomas Water Company and its water rights has SCWC failed to use some portion of those water rights for the provision of utility service. Certainly that was the case in 1994.

SCWC also criticizes our reliance on *In re Southern California Gas Co.* (1978) 84 Cal. P.U.C. 405. In that case, the gas company wanted to withdraw a portion of its existing natural gas transmission pipeline from utility service and to lease the facilities to an affiliate. The Commission found sufficient reason to remove the facilities from

public utility service because of the California capacity situation, and thus authorized the transaction. However, the Commission stated:

> "[D]etermination that justification exists for withdrawal is but one component in any Commission determination to authorize withdrawal from utility service and subsequent transfer and lease of public utility property pursuant to Section 851 of the Code. It is this Commission's duty, when public utility property is to be withdrawn and transferred, to assure that the transfer will not be adverse to the public interest. [Citation omitted]
>
> "In addition to merely documenting the existence of excess transmission capacity in the SoCal system, this Commission must also analyze economic and environmental factors to determine in what manner withdrawal shall be implemented so as to be consistent with the public interest."
>
> *Id.* at p. 418.

Again, SCWC argues the facts are not comparable; the facilities at issue in *Southern California Gas* had been used to serve the public, but the water rights at issue here had not. And again, we found differently. However, the additional importance of this case is that it delineates the process we must go through in reviewing a property transfer under section 851, in order to fulfill our own regulatory responsibilities. The Decision cites this case as an example illustrating how this Commission, long before 1994, conducted a thorough three-pronged review under section 851 before coming to its conclusion, and how it should have in this case done likewise, at the time the lease was contemplated.

SCWC continues its argument by applying section 851 to "the facts of this case." (App. Rhg., p.11.) The company asserts we err in concluding that the water rights at issue are useful utility property, because this conclusion ignores the testimony of the manager responsible for running the system, and the testimony of the company's experienced water rights counsel. SCWC states that by 1994, it had only used 3,451 of its 10,000 AFY allotment; the rest, including the 5,000 AFY to Folsom, were not being used, and had never been used by SCWC nor by its predecessor, Natomas Water Co.[4] SCWC was meeting customer demand. It could not foresee any use for the 5,000 AFY it leased; it projected it could meet future demand adequately through groundwater sources as well as its remaining 5,000 AFY of river water. As of 1993, it was using about 12,000 AFY in groundwater from its wells to serve customers.

SCWC argues that engineering and operational supply planning dictated using groundwater. It was plentiful and cheaper, since it did not require treatment the way surface river water did, and SCWC did not have the treatment facilities to process more than 5,000 AFY, which it could do at the Coloma Treatment Plant. (Cross examination of SCWC's witness Saddoris indicates that this assertion is at best misleading; SCWC currently contemplates running its Coloma plant 365 days a year instead of just 5 months of the year, in order to treat up to 10,000 AFY, until a new treatment facility can be constructed. (R.T., vol. 5, pp. 395, 413-414)) SCWC developed

[4] For decades, facilities for the diversion, transportation, and distribution of surface water were in place, and were maintained, by both Natomas and SCWC.

a business plan that called for reliance on groundwater rather than surface water, and submitted evidence of the planning process developed by SCWC's water manager and water rights counsel.

We continue to ask why all of this was not put before the Commission in 1994. Even if SCWC was so certain that these factors would put the transaction out of our reach, the appropriate action was to have come to us for a ruling to that effect. It chose not to do so at its peril, relying instead on its own evaluation that it did not need prior authorization under section 851.

SCWC criticizes the Decision's argument that SCWC should have retained the water rights as a kind of "insurance policy" (see D.04-03-039, p. 46), by arguing that we mention nothing that arose between the 1967 decision which authorized the assignment of the 22,000 AFY to Folsom and 1994 which would support a different result. However, this is not the point. SCWC had an obligation under law to come to us before leasing away its water rights, and it failed to do so. If we could see that nothing had changed between 1967 and 1994, so could SCWC. The company, therefore, should have had no reason whatsoever to want to avoid Commission review under section 851. Moreover, nothing that was said in the 1967 decision should have led SCWC to believe it was forever free from Commission scrutiny in terms of its water rights. Many utilities, as is evident from a number of the cases SCWC cites, come to us with an 851 request, stating they are uncertain whether 851 applies, but are coming to us out of

a sense of caution.[5] We then determine if our review is required by section 851. This is what SCWC should have done.

B. Alleged Violation of the U.S. and California Constitutions.

SCWC begins its argument by asserting that we have unconstitutionally extended our jurisdiction over SCWC's private property. SCWC contends that since our jurisdiction as established in Article XII, section 3 of the California Constitution is limited to public utilities – i.e., entities that have dedicated their property to public use – our assertion of jurisdiction over SCWC's allegedly completely private 5,000 AFY of American River water which has never been dedicated to public use is unconstitutional.

SCWC believes we misunderstand the nature of the water rights the company holds. In an apparent attempt to set us straight, the application for rehearing goes through a very lengthy discussion of such points as: 1) water rights are dedicated to public use only through an affirmative, unequivocal and voluntary action; the holder controls the extent of dedication, and a dedication of some portion of SCWC's water rights does not convert all of those rights to a public use and subject them to Commission regulation; 2) the public interest in dedicated water rights may be terminated through Commission consent or the end of public demands; 3) SCWC's American River water rights are private property that is transferable and divisible, and

---

[5] Some, unfortunately, do not, thus necessitating after-the-fact review, as here.

are dedicated to public use only to the extent of a 5,000 AF dedication after acquiring the system from Natomas.

SCWC's discussion, however interesting as a foray into some aspects of the law of private water rights, is largely irrelevant to whether SCWC should have regarded those additional 5,000 AF as an insurance policy, at least to the extent of seeking the Commission's opinion on whether it could lease them at will or not. Not surprisingly, SCWC's cases most frequently deal with water rights that were private property, not public utility property. More troubling to us is that many if not most of those cases concern private companies that are not even public utilities. SCWC is, of course, a public utility over whom we have jurisdiction. It cannot seriously expect that such inapposite authority will be persuasive to us.

The key to the entire argument here remains that the facts do not support SCWC. Its water rights came with the purchase of Natomas; Natomas itself was using a portion of this water for public use, and had been doing so for many years. Nothing in the documentation of the sale of Natomas to SCWC indicates that the water rights obtained from that sale had been Natomas' private rights; in fact, quite the contrary is true, from the language contained in the contract for sale. SCWC continued similar use to irrigation customers. While that use tapered off around 1970, the Coloma treatment facility was then constructed, which allowed use of up to 5,000 AFY of potable surface water.

As of 1994, SCWC was not using more than 3,451 AFY of surface water out of those 10,000 available. However, it is not the case that SCWC, a public utility water company, was prevented from starting to use more of its surface

water rights for municipal/residential/commercial customers because of the terms of its contract. That it was at the time limited by the extent of its treatment facilities may be true, but this does not mean it was incapable of changing that situation in the future – and in fact, it has, as more of its wells have become more seriously contaminated. Also, the fact that it was using only a portion of its surface water in 1994 does not lead to the legal conclusion that the surface water it was *not* using was transformed into private property, hence obviating the requirement that the Commission review what SCWC was doing with that 5,000 AF under section 851.

At no point between the time SCWC purchased Natomas and the time it entered the lease agreement with the City did SCWC declare that a portion of its water rights was private property. At no time did it use any of that water for its own private purposes. Given the context of its being a public utility, with a portion of its public utility resources being surface water rights, those rights did not become private property either before or upon SCWC's entering the lease agreement.

C. Alleged Taking of SCWC's Private Water Rights in Violation of the U.S. and California Constitutions.

SCWC argues that in restricting its use of private property, i.e., the 5,000 AFY of American River water that it leased in perpetuity to the City, we have taken its property without compensation, in contravention of the 5th and 14th amendments to the U.S. Constitution and Article I, section 19 of the California Constitution. As with its other arguments, SCWC's entire takings argument

rests on the position that the water rights in question are private, as opposed to utility, property. SCWC spends six pages of its application for rehearing presenting an analysis of takings law as it applies to private water rights. While this discussion is interesting, it simply does not apply if the water rights in question are not private property.

The takings argument fails from two standpoints. First, as we have repeatedly stated, SCWC's argument that the leased water rights are private property lacks merit; therefore, there is no taking – property that is useful to the business of providing water to the public cannot be taken by our lawful exercise of our jurisdiction under section 851. Second, looking now at the Modification Decision, we have determined that the lease is valid as to Folsom and have ordered SCWC to file a section 851 application (which it has done) for authorization of the lease. This is exactly what SCWC has, since 1994, wanted to do with the 5,000 AFY of water it was not already using to serve customers. Hence, even if there were a shred of merit to SCWC's argument about private property, nothing about our actions at this point, taking into account the Modification Decision, amounts to a taking of any property of SCWC.

D. Alleged Depriving SCWC of its Constitutionally Guaranteed Right to Use and to Dispose of its Property by Voiding the Lease.

SCWC cites what it terms a relevant part of Article I, section 1 of the California Constitution, as follows: "All people . . . have inalienable rights. Among these are . . . acquiring, possessing, and protecting property . . . . "

SCWC argues that the Decision violates this provision because "it interferes with SCWC's right to put to use, and capture value from, its water rights through a lease arrangement. That infringes on SCWC's right to use and dispose of its private water rights." (App. Rhg., p. 42.)

The answer to this claim is the same as for SCWC's taking argument. First, we have found that SCWC's water rights are not private. Secondly, the Modification Decision, with its finding that the lease is valid as to Folsom and its requirement that SCWC file an 851 application for the continuation of the lease, effectively continues the lease in force. That SCWC's choice to not come before us for prior authorization has resulted in a penalty and revised rate treatment, and that we may put certain conditions on SCWC for the future, are simply consequences that flow from SCWC's being a regulated water company.

E. Alleged Wasteful and Unreasonable Use of Water in Violation of Article X, Section 2 of the California Constitution Because The Decision Takes Water from an Existing Beneficial Use for Future Speculative Uses.

SCWC spends six pages of its application for rehearing (see App. Rhg., pp. 43-48) arguing that the Decision, in taking water from an existing beneficial use and subjecting it to future speculative uses, effectuates an unconstitutionally wasteful and unreasonable use of water. SCWC asserts:

> "[U]nless modified to expressly protect the rights of the City of Folsom to the maintenance of the water supply and expressly protect its right to continued water supply deliveries, Decision

> 04-03-039 effectuates an unreasonable use of water in violation of Article X, section 2 of the California Constitution." App. Rhg., p. 43.

The Modification Decision moots this argument by modifying the Decision to do exactly as SCWC has argued it must.

F. Alleged Unlawful Allocation of Lease Revenues to Ratepayers.

SCWC alleges that our allocation of 70% of the lease revenues to ratepayers is based on an erroneous assumption that ratepayers, not shareholders, have borne the cost of obtaining the water rights at issue as part of the purchase price of the Natomas Water Company. SCWC maintains that "SCWC's shareholder [sic], not ratepayers, paid for the purchase of the Natomas Water Company in 1964, and the Commission allowed the purchase price to be recorded in rate base." (App. Rhg., p. 49.) We have found that the value of the water rights obtained through this purchase was subsumed in the purchase price. If something is recorded in rate base, it contributes to the foundation from which future rates are derived. Thus on this basis alone, SCWC's argument fails.

SCWC goes on to argue that since no specific amount of the purchase price was attributed to water rights, they were obtained for free; thus ratepayers could not have paid for them. However, even if we were to adopt SCWC's position and conclude that the water rights were obtained for nothing, that means shareholders did not have to pay anything for them either. Under this scenario, it does not logically follow that all the proceeds from the lease should go to shareholders.

SCWC then argues that even if some portion of the purchase price was allocated to water rights, ratepayers did not pay for these rights. This is because, according to SCWC, water rights are real property, and under the Commission's ratemaking rules, ratepayers do not reimburse shareholders for the cost of purchasing real property. SCWC cites two Commission decisions in support of this proposition, neither of which is helpful to its argument.

In re Pacific Gas & Elec. Co. (2001) D.01-05-076, 2001 Cal. P.U.C. LEXIS 284, involved the sale of certain parcels of land on which PG&E had hoped to construct a power-generating wind farm. These parcels were not in rate base and were non-utility property. The Commission awarded the entire gain on sale to shareholders, reasoning that shareholders had borne the risk for the property. The Commission stated: "In particular, we note that rates support none of the maintenance costs, property taxes, or other costs associated with non-utility property." *In re Pacific Gas & Elec. Co.* (2001) D.01-02-044, 2001 Cal. P.U.C. LEXIS 88, also involved the sale of non-utility property not in rate base (land on which PG&E had planned to build a substation, which was never built).

These cases are quite different from the one before us, where we have concluded that the water rights at issue *are* utility property. The entire cost of the Natomas Water Company purchase, which included 32,000 AFY of water rights, was part of rate base. Ratepayers have been paying shareholders a rate of return on that investment; shareholders have not paid ratepayers anything. As the water rights were not depreciable, this return never decreased. Shareholders were not responsible for recovery of any of the carrying costs. It is completely appropriate under the

facts of this case that ratepayers should receive a portion of the proceeds of the lease from its inception. Similar results have been reached in situations where a rate based item has been sold (rather than leased in perpetuity). Cf. *Democratic Central Committee of D.C. v. Washington Metropolitan Area Transit Commission* (D.C. Cir. 1973) 485 F.2d 786 (cert. denied 1974, 415 U.S. 935). To alleviate any misunderstanding of the rationale underlying our allocation, we will clarify the discussion in the Decision in several respects, in accord with this discussion.

G. Alleged Application of an Illegal Interest Rate.

SCWC argues that the 7% interest rate the Decision applies to the refund of 70% of the lease revenues to ratepayers is arbitrary and unlawful. SCWC maintains there is no Commission precedent for so large an interest rate, and that by analogy to memorandum accounts, the interest rate should be the 90-day commercial paper rate.

SCWC accurately points out that our practice for funding memorandum accounts and other short term liabilities has often been to apply the 90-day commercial paper rate. However, we are not bound by that practice when the facts and circumstances do not warrant it. We do not believe the 90-day commercial paper rate is appropriate here, where SCWC has been crediting the revenues from the leased water rights to shareholders for nearly 10 years. As the Decision indicates, a strong argument can be made that the interest rate should be fixed at SCWC's authorized rate of return for the Arden-Cordova district. That represents the return that SCWC's shareholders could be expected to have achieved on the lease revenues,

which under SCWC's unauthorized treatment went entirely to shareholders for that lengthy period of time. Instead, however, we have decided to adopt ORA's *lower* proposed interest rate of 7%. This is appropriate, given all the facts and circumstances before us. As with our allocation discussion, we will clarify our discussion of this issue accordingly.

H. Alleged Imposition of an Unlawful and Unwarranted Fine.

There is no question that we have the authority to impose fines for violation of statutes, regulations, and our own orders. Sections 701, 2107, 2108. The legal conclusion that SCWC violated section 851 by not coming to us prior to signing the lease agreement with the City forms the basis for imposition of the fine. There is nothing unlawful about this. As the Decision makes clear, we made the calculation after analyzing the facts according to the standards we routinely use in determining the appropriate amount of fine to impose. Rather than imposing even the minimum fine allowable,[6] we have fined SCWC the amount urged by ORA – $180,000 (based on $20,000 for the section 851 violation and an additional $20,000 for each year SCWC did not record the revenues correctly) – and have suspended the remainder. This fine is very minimal for a company the size of SCWC. To put this in some perspective, the Decision authorizes a rate increase for SCWC's Region III Service Area of over $8 million in 2003 alone, which is a 12.6% increase over existing rates in that Service Area. SCWC's recently filed section 851

[6] $1,095,000; see D.04-03-039, p. 57.

application shows total company revenues (water and electric) approximating $212 million for the 12 months ending in May 2004. This claim has no merit.

THEREFORE, IT IS ORDERED that:

1. Decision 04-03-039 is modified as follows:

   a. The second, third, and fourth paragraphs of the discussion entitled **"B. Ratemaking Treatment for Lease Revenues"** on pages 54-56 are modified to read:

      "We do not accept that proposition. When SCWC purchased the Natomas Water Company in 1964, the transfer of water rights was included in the transaction. As even SCWC admits, certain amounts of those rights were exercised previously by the Natomas Water Company and subsequently by SCWC. The entire cost of the Natomas Water Company purchase, which included 32,000 AFY of water rights, was part of rate base. Ratepayers have been paying shareholders a rate of return on that investment; shareholders have not paid ratepayers anything. As the water rights were not depreciable, this return never decreased. Shareholders were not responsible for recovery of any of the carrying costs. We see no reason to assign the full benefit of the water rights to shareholders merely due to the fact that as SCWC states, 'At that time – 1963 – it was common practice to attach no monetary value to water rights

and therefore SCWC acquired these water rights for free.' [Fn omitted.] The fact that the parties may not have assigned a particular line item value to the water rights does not mean those rights were free, especially since Natomas had obtained a benefit from the exercise of some of those water rights. Notwithstanding the lack of a separate itemization of the value of the acquired water rights, it is clear that the value of those property rights was included in the overall purchase price paid by SCWC. We determine that the entire amount of water rights was utility property at the time of the purchase. After the 1967 sale to Folsom, the entire remaining 10,000 AFY, which includes the 5,000 AFY being leased to Folsom, continued to be utility property.

"Based on the fact that ratepayers have paid to, and for, shareholders the carrying costs (i.e., rate of return) of these water rights as part of the purchase price of Natomas, it is reasonable to allocate to ratepayers most of the benefits of the lease from its inception. Similar results have been reached where a rate based item has been sold rather than leased (in perpetuity). Cf. *Democratic Central Committee of D.C. v. Washington Metropolitan Area Transit Commission* (D.C. Cir. 1973) 485 F.2d 786 (cert. denied 1974, 415 U.S. 935). On the other hand, it is appropriate to assign shareholders a minority of the lease revenues in order to provide some

reward for the leasing of an asset that probably would have been underutilized for most of the period from 1994 to the present had it not been leased. Based on these considerations and the unique facts of this case, we determine that 70% of the lease revenues should be assigned to ratepayers and 30% to shareholders. This apportionment should apply to any lease revenues accrued from the inception of the lease through the date of this decision.

"SCWC's failure to seek section 851 review for the lease creates an unfortunate issue of how to enable ratepayers to gain the benefit of their appropriate 70% share of the revenues that SCWC previously has unilaterally assigned for the benefit of shareholders. We agree with ORA that the best approach is to require SCWC to credit customer bills by the appropriate ratepayer share, plus interest. A strong argument can be made that the interest rate should be fixed at SCWC's authorized rate of return for the Arden-Cordova district. That represents the return that SCWC's shareholders could be expected to have achieved on the lease revenues, which under SCWC's unauthorized treatment went entirely to shareholders. Instead, however, we will adopt ORA's *lower* proposed interest rate of 7%. Accordingly, SCWC is required to refund to ratepayers 70% of lease revenues accrued from the inception of the

lease through the effective date of this decision, plus 7% interest."

b. Subsection **B** at the bottom of page 56 should be re-labeled **C**.

c. Finding of Fact 30 is modified to read:

"The entire cost of the Natomas Water Company purchase, which included the rights to 32,000 AFY of American River water, was included in rate base.

Ratepayers have been paying shareholders a rate of return on that investment; shareholders have not paid ratepayers anything. As the water rights were not depreciable, this return never decreased. Shareholders were not separately responsible for any of the carrying costs."

d. Conclusion of Law 30 is modified to read:

"Because ratepayers have borne the carrying costs (rate of return) of obtaining the water rights that were leased to the City of Folsom, and yet, on the other hand, leasing those water rights has resulted in a beneficial use that may not have been realized absent the lease, it is reasonable to allocate 70% of the benefits of the lease to ratepayers and 30% to shareholders, from the inception of the lease until the effective date of this decision."

2. The application for rehearing filed by the Southern California Water Company of Decision 04-03-039, as

modified by Decision 04-04-069 and the decision herein, is denied.

3. This proceeding is closed.

This order is effective today.

Dated September 2, 2004, at San Francisco, California.

MICHAEL R. PEEVEY
President
CARL W. WOOD
LORETTA M. LYNCH
GEOFFREY F. BROWN
Commissioners

I will file a dissent

/s/ SUSAN P. KENNEDY
Commissioner

Decision No. 71889

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

In the Matter of the Application of SOUTHERN CALIFORNIA WATER COMPANY and CITY OF FOLSOM for an order authorizing the sale of certain properties of Southern California Water Company.	Application No. 48786 (Filed September 13, 1966)

O'Melveny & Myers, by *Donn B. Miller*, for Southern California Water Company; McDonough, Holland, Schwartz, Allen & Wahrhaftig, by *Martin McDonough*, for City of Folsom, applicants.

John D. Reader, for the Commission staff.

OPINION

This request of Southern California Water Company (seller) and City of Folsom (buyer) for authority to transfer seller's water system serving the Folsom area in Sacramento County to the City of Folsom was heard before Examiner Coffey in San Francisco and submitted for decision on November 7, 1966.

The Folsom system of seller does not lie entirely within the limits of the City of Folsom. However, substantially all of the nearly 1,500 customers served through the property to be transferred are within the city limits of the City of Folsom. The largest single customer of the system, Aerojet General Corporation, is outside the City and is served under the terms of a special contract.

On August 22, 1966, seller and buyer entered into an agreement, a copy of which is attached to the application as Exhibit II, providing for the sale of the seller's Folsom water system used in connection with the performance of public utility service by seller. The agreed cash purchase price is $825,000, plus an amount equal to the cost to seller of all approved capital additions.

The properties of the Folsom District are recorded on seller's books, as of August 31, 1965, as follows:

Utility Plant	$913,280
Reserve for Depreciation	(178,197)
Advances for Construction	(109,660)
Contributions in Aid of Construction	(42,660)
Net	$582,763

Seller states that at or substantially concurrently with the sale of these properties it will repay all deposits, including accrued interest, made by its Folsom customers to establish credit.

Buyer, under the terms of the agreement, shall assume the obligations of seller for reimbursement of advances for construction under the terms of the contracts relating to such advances upon the transfer of the property associated with such advances.

Buyer, having determined to acquire the properties which are the subject of this request, petitioned this Commission in Application No. 46026 to determine the just compensation for essentially the same properties. Application No. 46026, now pending before the Commission, is being held in suspense pending the negotiations which led to the agreement herein being considered. Buyer and seller state that the agreement is preferable to the

expensive and uncertain results of protracted litigation and that the compromises reflected in the agreement were arrived at in arm's length bargaining and represent an attempt to arrive at a workable and logical result rather than the parties' judgment concerning the outcome of such litigation.

In addition to the Folsom water system, seller also serves water in the area of Cordova which is adjacent to the Folsom system and traversed by the Valley Canal, one of the properties to be transferred to buyer. The agreement provides that buyer shall have eleven-sixteenths fractional interest in all water and water rights, in and to the flow of the South Fork of the American River, which are owned or claimed by seller on the closing date. At such time as seller can obtain the diversion of its water from the to-be-constructed Folsom South Canal, buyer will transfer to seller without cost that part of the Valley Canal below the point at which the Valley Canal is intersected by the Folsom South Canal. A witness for seller testified that there are adequate water supplies to serve present and future customers in the Cordova area and that no shortage of water was anticipated as a result of this transfer of properties in the foreseeable future.

We find that:

1. The terms of the purchase agreement adequately protect the interest of customers and refund contract holders in deposits and advances for construction.

2. Buyer has the ability to acquire and operate seller's Folsom water system without interruption in service.

3. The dedicated area of service of seller's Folsom water system extends outside of the boundaries of buyer.

4. Adequate supplies of water are available to serve seller's customers in the Cordova certificated area.

5. Upon the consummation of the proposed transfer seller will no longer be performing public utility service in the area of the properties to be sold.

6. Subject to the conditions set forth in the order which follows, the proposed sale and transfer will not be adverse to the public interest.

We conclude that the application should be granted as provided by the following order.

ORDER

IT IS ORDERED that:

1. Within one year after the effective date of this order, Southern California Water Company may sell and transfer to City of Folsom the properties referred to herein, substantially in accordance with the terms described in the agreement attached to the application herein and designated as Exhibit II, but subject to the conditions of this order.

2. Before the transfer of its water system assets, seller shall return to customers any refundable deposits made to establish credit and shall file a statement that all deposits have been refunded with the Commission within ten days after said transfer.

3. The foregoing authority is conditioned upon the filing in this proceeding of a stipulation by buyer that:

(a) Buyer will be subject to all legal claims for water service which might have been enforced against seller, including such claims as may exist in territory outside of buyer's boundaries.

(b) As to the rates, rules and conditions of service which buyer will apply in the service area of the system herein authorized to be transferred, it will not discriminate between service rendered outside its city boundaries and service rendered inside said boundaries, except insofar as it may adjust such outside rates and charges to offset any reasonable tax burden sustained by water users within the city in subsidizing the operation of the city's water system.

4. Upon compliance with all of the conditions of this order, seller shall stand relieved of all of its public utility obligations in the area served by the transferred system, and may discontinue service concurrently with the commencement of service by buyer.

5. Within ten days after the date of actual transfer, seller shall file in this proceeding written notice of the date of transfer, the date upon which buyer shall have assumed operation of the water system authorized herein to be transferred, and a true copy of the instrument or instruments of transfer which may be executed to effect such transfer.

The effective date of this order shall be twenty days after the date hereof.

Dated at San Francisco, California, this 24th day of JANUARY, 1967.

/s/ Peter E. Mitchell
President

/s/ William M. Bennett
/s/ Augustus G. Gatov
/s/ Fred P. Morrissey

Commissioners

Commissioner WILLIAM SYMONS, JR. did not participate in the disposition of this proceeding.

Decision No. 67299

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

In the Matter of the Application of NATOMAS WATER COMPANY and SOUTHERN CALIFORNIA WATER COMPANY for an order or orders (a) authorizing the sale of the public utility water system property of Natomas Water Company to Southern California Water Company; (b) authorizing Natomas Water Company to refund certain consumers' deposits; (c) authorizing Southern California Water Company to render water service to the public in the territory served by Natomas Water Company at the rates of Natomas Water Company presently in effect and authorizing Natomas Water Company to discontinue rendering water service and relieving Natomas Water Company of further utility obligations; (d) authorizing Southern California Water Company to assume certain liabilities of Natomas Water Company; and (e) authorizing Southern California Water Company to exercise rights under any franchises to be acquired by it in order to render water service in the area presently served by Natomas Water Company.

Application No. 46058
(Filed December 23, 1963)

Downey, Brand, Seymour & Renwer, by *Harry B. Seymour* and *John F. Downey*, for Natomas Water Company.
O'Malveny & Meyers, by *Lori J. Miller*, with *C. T. Mass*, Consulting Engineer, for Southern California Water Company.
Louis A. Boli, III and *Martin McDonough*, for City of Folsom, and *John E. Kapp, Jr.*, in propria persona, interested parties.

OPINION

Natomas Water Company seeks authority to sell its operating utility properties in Sacramento County to Southern California Water company, which joins in the application. Copies of the purchase agreement and other documents relating to the sale are annexed as exhibits to the application or are included in the record as Exhibits A through G. The basic price to be paid by purchaser for the properties is stated to be $1,095,410.00. The application was submitted for decision at the conclusion of a public hearing held, after due notice, before Examiner Cline at Sacramento on February 25, 1964.

Natomas is a California public utility corporation which for many years has supplied water for domestic and other uses in and in the vicinity of the City of Folsom.

Southern California is a California public utility corporation which, following consolidation of some twenty public utility corporations in 1929 and with subsequent acquisitions and additions, has rendered public utility water service in the counties of Los Angeles, Kern, San Bernardino, Orange, Imperial, Ventura and Sacramento, through sixteen operating districts.

The purchase agreement, in which the properties are described, recites that buyer, after acquisition, will assume seller's obligations to refund advances for construction and that seller will refund all customers' deposits to guarantee credit due and payable as of the closing date; all such deposits not then due and payable will be transferred to buyer for refund when due.

The record reveals that Southern California has adequate financial resources with which to purchase the properties and that it proposes to render water service to the public in the territory served by Natomas, through the property being sold, at rates of Natomas presently in effect.

The purchase agreement recites, and the record shows, that the City of Folsom has evidenced an interest in acquiring the Folsom division of Natomas' properties and is opposed to authorization of the sale of that portion of the system.[1]

The city, at the hearing, moved to hold this transfer proceeding in abeyance pending outcome of its petition for determination of just compensation, and later submitted a petition to the same effect, signed by a number of residents (Exhibit H). Both Natomas and Southern California opposed the motion on the grounds that: (1) ownership of the properties at the time of condemnation would not affect the issue of just compensation or otherwise be

[1] The record shows that the city filed a petition of the second class on December 11, 1963 (Application No. 46026), for determination of just compensation for the Folsom Division properties, and that certain preliminary proceedings have been had in connection therewith (Public Util. Code, Sec. 1401, et seq.).

prejudicial to the city or its residents in such a proceeding; (2) the delays attendant upon fixing just compensation by the Commission and holding an election by the city could impede construction of facilities to meet growing demands if, during the interim, the ratio of advances for construction to Natomas' total utility plant (less depreciation reserve) should exceed 50%, thus requiring specific authorization by the Commission for any main extensions required to provide additional service (*Water Main Extension Rule*, 60 Cal. P.U.C. 318, 327, par. A.2.a.).

The motion to hold the instant application in abeyance should and will be denied. It is well settled that a proceeding in eminent domain, in which the commission's function of fixing just compensation is an integral part where public utility properties are being taken, is an action *in rem*, in which everyone who can possibly be affected by the decision has a right to appear and assert his own rights. Granting the herein request to transfer could not possibly prejudice the City of Folsom.

There is nothing in the record of the instant transfer proceeding, or in the present posture of the just compensation petition, to suggest that a delay in issuing our transfer authorization would serve any useful public purpose.

We find that the proposed transfer is not adverse to the public interest. It will, therefore, be authorized in accordance with the ensuing order. Such authorization, however, shall not be construed as a finding of the value of the rights and properties herein authorized to be transferred, or as indicative of amounts to be included in proceedings for the purpose of determining just and reasonable rates.

ORDER

IT IS HEREBY ORDERED that:

1. Natomas Water Company, a corporation, after the effective date of this order, may sell and transfer and Southern California Water Company, a corporation, may purchase, take and operate the public utility properties and rights described in the purchase agreement herein, dated December 19, 1963 (Exhibit B attached to the application and in evidence) substantially in accordance with the terms and conditions of said agreement and subject to the provisions of this order.

2. Southern California Water company, after acquisition of the properties herein authorized to be transferred, may exercise any certificate, franchise, right of way, license or permit, including those specifically referred to in said purchase agreement, in the areas presently served by Natomas Water Company through the properties herein authorized to be transferred.

3. On or before the date of actual transfer, seller shall transfer and deliver to buyer, and buyer shall receive and preserve, all records, memoranda and papers pertaining to the construction and operation of the properties herein authorized to be transferred, subject to access by seller, however, as provided in said purchase agreement.

4. Within thirty days after the consummation of the transfer herein authorized, buyer shall notify the Commission, in writing, of such consummation and within said period shall file with the Commission a true copy of any deed, bill of sale, agreement or other instrument which may be executed to effect said transfer, together with

copies of all journal entries which may be used to reflect said transfer in buyer's books of account.

5. The tariff service area map, rate schedules renumbered to be in harmony with buyer's tariffs, ditch system rules and lists of contracts and deviations of seller now on file with this commission shall be refiled within thirty days after the date of actual transfer under the name of Southern California Water Company in accordance with the procedure prescribed by General Order No. 96-A, together with such revised and additional tariff sheets acceptable to the Commission, as are necessary to provide for the application of Southern California Water Company's present rules and forms to service in the area transferred herein.

6. On or before the end of the third month, after the consummation of the transfer as herein authorized, buyer shall cause to be filed with the Commission, in such form as it may prescribe, an annual report, or reports, covering the period commencing with the first day of the current year to and including the effective date of the transfer.

7. Upon completion of the transfer herein authorized and due compliance with all the provisions of this order, Natomas Water Company, a corporation, shall stand relieved of all further public utility obligations and liabilities in connection with the operation of the public utility water system and properties herein authorized to be transferred.

8. The authority herein granted will expire if not exercised within one year after the date of issuance of this decision.

The effective date of this order shall be twenty days after the date hereof.

Dated at San Francisco, California, this 3rd day of June, 1964.

WILLIAM M. BENNETT
President
PETER E. MITCHELL
EVERETT C. McKEAGE
GEORGE G. GROVER
FREDERICK B. HOLOBOFF
Commissioners